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PRIME MINISTER

INDEXED GILT-EDGED STOCKS

At your Monetary Seminar on 18 November you asked me to prepare a paper setting out the pros and cons of issuing index-linked gilts with carefully defined eligibility criteria to ensure that they were not taken up by non-residents. I accordingly attach such a paper.

It has been prepared on the assumption that an issue of the kind described in the earlier paper sent to you by the Chancellor on 14 November is a practical possibility. In other words, that a method of enforcing the proposed restriction to pension funds and life insurance companies (but only in respect of their UK pension business) can be found that would be acceptable to the industry. Officials are currently looking at a slightly revised version of the prospectus which might go some way towards resolving the problems raised in the annex to John Nott's letter of 17 November.

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Essentially, there are four main arguments against indexed debt:

(a) There could be an adverse effect on expectations if the Government were thought to have abandoned their efforts to curb inflation;

(b) it would be inconsistent with the Government's attempts to reduce indexation in other areas, such as social security benefits and public sector pay;

(c) there could be damaging consequences for the finances of the company sector; and

(d) an issue of restricted stock could have a harmful effect on the funding programme generally if the institutions held off buying conventional gilts in the hope of forcing the Government to extend indexation.

There are strong counter-arguments, which are set out in more detail in the paper. Very briefly, I believe our monetary policy to be the key influence on inflationary expectations and that indexed debt issued in that context would be seen as a sign of confidence rather than defeatism. Long-term debt issues are quite different from wage or benefit contracts, which cover short periods of around a year, so that the charge of inconsistency is not, in my view, well-founded. Indeed, it is significant that our recent substantial extension of index-linked National Savings Certificates caused no expectational or presentational difficulties whatever - rather the reverse, in fact. In the case of the indexed gilt, the price of the stock would fluctuate with market conditions, and this will determine whether a lender earns a positive or negative real rate of return. As for the effect on the company sector, companies will benefit from the overall reduction in interest rates which we expect. And while there are always risks involved in any change in funding techniques, I have little doubt that the potential benefits far outweigh the dangers. Events since our meeting on 18 November have underlined the urgency of the need for improvements on this front.

I remain convinced, therefore, that indexed gilts would be a valuable addition to our financial armoury. This, for the following main reasons:

(a) Indexed gilts would eliminate the substantial risks incurred with conventional gilts by both investors and the Exchequer owing to the inherent uncertainty about future rates of inflation, and as a result investors should be prepared to accept a lower true rate of interest in return for insurance against inflation. This can be expected to reduce the overall cost of servicing Government debt.

(b) In addition, the risk of HMG having to pay very high interest in real terms as inflation comes down would be effectively eliminated. The opposite argument, to the effect that we have funded the national debt cheaply in recent years and may continue to do so by conventional means, rests on the massive acceleration of inflation in the 'seventies and futher depends on the assumption

of continuing high and indeed accelerating inflation in the 'eighties. I am sure we should not base our funding policy on such a proposition, which amounts to little short of a confession of expected failure which markets would be quick to seize on.

(c) There would also be significant improvements in monetary control. Pauses in the funding programme as a result of market expectations of higher inflation could be avoided, since it would then be easier to sell indexed rather than conventional gilts at an acceptable price. The intention is not, of course, to remove conventional gilts from our armoury altogether, but to ensure that both types of stock are on offer. Each will have its market: at some times it will prove easier to sell the one and at other times the other.

(d) The net result is that it should be possible to achieve a given monetary target at lower levels of interest rates, with beneficial effects throughout the economy.

(e) There would also be some gain from a reduction in the PSBR, and this would have obvious presentational advantages. There is no doubt that the gilts market is heavily influenced by PSBR figures, and this would bring a further advantage in terms of monetary control.

Although the above arguments concentrate on the macroeconomic implications, there is also another dimension, raised by the Report of Sir Bernard Scott's enquiry into public sector inflation proofed pensions. The report recommends that the Government give serious consideration to an issue of index-linked bonds to be held by private sector pension funds, thus achieving a greater degree of equity between those who work in the private and public sectors.

I hope this minute, and the attached paper, will provide a basis for a discussion so that we can reach an early decision in principle whether to go ahead with indexed gilts, subject to later decisions on eligibility and timing.

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I am copying this minute, and the paper, to Geoffrey Howe, Leon Brittan, John Biffen, Keith Joseph, Gordon Richardson and Sir Lawrence Airey.

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NIGEL LAWSON
13 January 1981

INDEXED GILT-EDGED STOCKS

This paper summarises the arguments for and against issuing index-linked gilts for which only pension funds and, in respect of their pension business, life offices would be eligible. The main reasons for considering this are:

(i) because the risks associated with uncertainty about future inflation would be removed, the cost of Government borrowing by means of index-linked gilts is likely on balance to be less than for conventional gilts, and the risk of HMG having to pay very high interest rates in real terms as inflation comes down would be effectively eliminated;

(ii) there could be improvements in monetary control because funding pauses associated with worsening inflationary expectations would be less likely;

(iii) it should be possible to achieve the Government's monetary objectives with a somewhat lower general level of interest rates;

(iv) the PSBR would be reduced.

The sections which follow consider these, and other relevant issues, in more detail.

Indexation and Inflation

2. A key issue in the debate about whether to issue index-linked gilts, and about indexation more generally, is the impact on inflation. It can be argued that in issuing indexed gilts the Government would be indicating that they were reconciled to a continued high level of inflation, and had abandoned serious attempts to bring the rate down.

3. On the other hand the key influence on expectations in the medium term is the Government's commitment to control inflation. If this did not change, there is no reason to believe that indexed gilts would affect expectations adversely. Indeed the issue of indexed debt should have a favourable impact, particularly if issued at a time when the inflation rate was falling and a further fall was expected. The authorities could point out that by issuing indexed debt at such a time in addition to conventional gilts the Government were making clear their own belief that inflation would fall, and their commitment to ensuring that it did. Governments which hoped to escape from their obligations through inflation would be the last to issue index-linked debt. Indeed it has frequently been argued that it is sales of conventional gilts which give Governments a vested interest in maintaining a high inflation rate. There is thus no good reason to believe that the issue of indexed gilts would be seen as a weakening of the Government's resolve to pursue policies designed to control inflation.

Interest Rates and the PSBR

4. It is argued that in recent years the Government have been able to fund the PSBR at negative real interest rates, resulting in a decline in the real level of the National Debt. If the Government were to issue indexed gilts the chance would be forfeited of very cheap financing in real terms if inflation were unexpectedly high. Throughout the 1970s HMG have been paying interest on low-coupon debt sold in the 1960s. The issue of indexed debt now could necessitate huge repayments at the end of the century if inflation sharply accelerates again.

5. There are two main counter-arguments. In the first place, the reason that fixed interest long-term debt has proved a cheap financing method for the Government in the last decade is that during the 1970s as a whole the average rate of inflation was, contrary to expectations when the debt was issued, considerably higher than it had been in the 1950s and 1960s. We could only expect to make similar savings again if the 1980s prove to be a period during which inflation continues to accelerate - but from a much higher base. This is not an acceptable assumption on which to base funding policy.

6. Secondly, indexed debt can be expected to contribute to a general reduction of interest rates, and thus in the cost of servicing Government debt. In an economy subject to wide variations in the rate of inflation, a fixed nominal yield represents a gamble for both borrowers and lenders. If, by indexing the principal of the loan, the Government removes the element of uncertainty due to inflation, this will benefit both lenders and borrowers and should allow the indexed debt to be sold more cheaply than conventional debt. For a particular issue of indexed stock, who 'gained' or 'lost' in the event would depend on how the rate of inflation compared with expectations at the time the indexed debt was issued. But if there is no systematic market tendency to overestimation or underestimation of inflation, the cost of Government borrowing should be lower than for conventional debt. This argument does not depend on any assumptions about the Government's ability to forecast inflation more accurately than the market or vice versa: it is the overall reduction in uncertainty that is relevant. A further consideration is that the issue of indexed gilts should reduce the demand for money to some extent, and this would allow a lower general level of interest rates consistent with achievement of the Government's monetary targets. This will reduce interest rates on comparable instruments such as corporate debentures.

7. There would, furthermore, be an immediate reduction in the PSBR as, on the basis of existing statistical conventions, only the small real interest coupon would be credited as debt interest payments. Thus if £2 billion were issued in indexed form with a coupon of 2%, as opposed to conventional gilts with a 12% coupon, the saving would be £200 million per annum and with a continuing programme of sales this would build up steadily over time. The reduction would be accompanied by an automatic increase in the value of existing gilt holdings, and hence a reduction in the demand for new stocks. But there would remain a significant presentational gain and for a considerable period, until indexed gilts began to be redeemed, the automatic refinancing of the PSBR would yield benefits in terms of monetary control.

Effects on the Company Sector

8. There is concern about the potential impact of indexed gilts on the company sector. It is possible that the effect would be to increase the cost of capital to industry. Because they both offer compensation for inflation, indexed gilts and equities would be fairly close substitutes, so the institutions could switch out of equities to a significant extent, perhaps leading to some decline in share prices. This would increase the cost of equity finance and further delay the revival of the new issues market with potentially adverse consequences for the money supply. The only way for companies to respond would be to issue indexed debt themselves, but there are problems. In particular, the present tax treatment is not ideal for the issue of indexed bonds, since, in theory at least, only the small real coupon is allowable as interest expense (but see para 10).

9. On the other hand companies would benefit from the general reduction in interest rates which is likely. Both bank borrowing and debenture finance would be cheaper. A revival of the debenture market would take some of the pressure off bank lending, with significant benefit to the money supply and hence possibly still lower interest rates. On balance there may be some changes in relative costs of different types of finance but no overall increase in companies' cost of capital. In the longer term, if indexation were to become more prevalent, there might be changes in the financial structure of companies, but these would be gradual and could be beneficial.

10. It has to be recognised that companies wishing to issue indexed debt do face problems, and none have done so as yet. But of late there have been indications of interest, and the Bank recently let it be known that it was no longer opposed to the idea in principle. On the tax question, Rothschilds have proposed a scheme whereby at maturity the capital uplift on indexed stock would be deemed to be deferred interest and allowable against tax. The Inland Revenue agree that this would be acceptable. The problem remains, however, that companies may have insufficient taxable income in a given year to take advantage of the tax allowance. Treasury, Bank and Inland Revenue officials are looking into ways in which this problem might be eased.

Monetary Control

11. It is argued that criticisms of current gilts marketing techniques are much exaggerated and that innovations are not needed. The system has allowed HMG satisfactorily to fund high levels of PSBR for a number of years. Indexed gilts would be of no help if the market expected an upward movement in nominal interest rates in the absence of any change in inflationary expectations, and in these circumstances there is no guarantee that they would be any easier to sell than conventional gilts. Furthermore, the market, once it had been given a taste of indexation, might hold off purchasing ordinary gilts in the hope of inducing the Government to offer more indexed gilts or to extend eligibility. We might thereby create a funding pause of just the sort that the exercise is designed to prevent.

12. However, the issue of indexed gilts would give the authorities a new instrument which offers the prospect of significant improvements in monetary control. There is little doubt that institutions like pension funds with long-term liabilities related to the general level of earnings would find them attractive. Although in the first instance it would be advisable to issue them at a time when inflation was falling so as to secure a favourable effect on expectations, in terms of monetary control the most important benefits would accrue at times of uncertainty about the prospects for inflation. In those circumstances, conventional gilts would be difficult to sell before an adjustment of yields had taken place. With present techniques, this might require action by the authorities such as a rise in MLR and interest rates generally - the Duke of York technique. And the risk premium which investors would require would further add to the cost of Government borrowing. Indexed gilts, on the other hand, would be easier to sell, partly because it is envisaged they would be sold by tender. Our present difficulties in selling debt by conventional methods on anything like the scale necessary to fund large and foreseen monthly borrowing requirements underline the potential gain to monetary control from an increase in the range of instruments available. Also, as noted above, an issue of indexed gilts would reduce the PSBR, and the funding programme would be somewhat less at risk in the face of fluctuations in market sentiment because a degree of automatic financing would be involved.

Exchange Rate Effects

13. An unrestricted issue of indexed gilts is open to the objection that it might encourage substantial inflows from non-residents, particularly OPEC investors. There is a risk that inflows of this kind could exert substantial upward pressure on the exchange rate, although analyses by Bank and Treasury economists suggest that on balance and over time the effect on sterling would probably be relatively slight, largely because of the offsetting effect of the reduction in interest rates. However, the risk of a disruptive short-term upward movement, apparently caused by Government action, cannot be ruled out. If, therefore, it were to prove impossible to restrict eligibility to hold the stock in the way we propose we would need to make a choice between confining eligibility to the pension funds and extending it to all life insurance business. In this event, the potential exchange rate consequences of the latter (if foreigners were to buy index-linked UK insurance policies on a lower scale) would need further study. We would then need to weigh the risks of upward pressure on the exchange rate against the disadvantage of the 'pension funds only' course, which would expose us to the charge of discrimination against the self-employed and employees of smaller companies, who are the main pension customers of life offices.

On the other hand, a restricted issue of the kind currently under consideration would not be open to objection on these grounds, since the eligibility criteria are drawn in such a way as to exclude direct overseas purchases and to prevent non-residents' access, while effectively treating all forms of private sector pension provision equally. The restrictions envisaged are not 100 per cent watertight, and the possibility of some 'leakage' overseas cannot be entirely disregarded, but the danger is minimal.

Presentational Impact on Indexation Policy Elsewhere

14. It is argued that while the Government are attempting to eliminate or modify indexation elsewhere in the economy, indexation of debt would appear inconsistent. Past experience of indexation, whether of wages (threshold agreements) or transfer payments or tax thresholds, has shown that the Government's room for manoeuvre is seriously constrained and unwelcome rigidities in the cost structure of the public

sector are created. Thus in the areas of social security benefits and public sector pay the Government have recently taken steps to weaken the link with inflation increases. It might appear that creditors were being treated differently from benefit recipients or employees.

15. The counter-argument is that the sale of a long-term debt instrument is a quite different transaction from a wage contract or a benefit uprating, so that issuing indexed debt would not be inconsistent with de-indexation elsewhere. Debt contracts are much longer, and hence potential gains and losses through failure to index are much greater than for annual contracts. In any event there would be no question of guaranteeing full compensation for inflation, as is the case with wage, benefit, or pension indexation. The price paid for stock would determine whether investors obtained a positive or negative real return, and they could be sure of this only if they held the stock until maturity. During the life of the stock, its price would fluctuate with market conditions, and investors would still face uncertainty about variations in real interest rates. Direct comparisons between creditors and employers or beneficiaries are therefore not valid. Any presentational problems would of course be easier by the precedent for indexed Government debt already established in the shape of 'Granny' bonds. It is worth noting that the recent extension of these has been favourably interpreted by the market.

Benefits for Pensioners

16. The eligibility criteria currently proposed make it very clear that the Government intends the new indexed gilts to be taken up by pension funds and life assurance companies which do pension business. The Wilson Committee argued that the issue of index-linked gilts would be a very significant improvement in the range of assets available for long-term savings institutions and would greatly increase the confidence with which they could issue index-linked liabilities of their own. The Scott Report on the value of public sector pensions recommends that "the Government should now look seriously at the case for issuing indexed bonds to cover pension liabilities". Assuming public sector indexed pensions are to continue, the issue of indexed gilts available to all pension funds could be seen as an attempt to encourage

some equalization of treatment between the public and private sectors.

International Experience

17. Opponents of indexed gilts argue that other countries' experience of indexed debt has been almost wholly negative. Pressure from OPEC surplus countries for indexed bonds has been generally resisted in OECD. (Since these instruments would not be open to purchase by non-residents, the issues raised there are not relevant.) A number of countries have, nonetheless, experimented with various kinds of indexed bonds - Brazil, Chile, Israel, New Zealand, Finland, France. Some have abandoned the experiment, notably Finland where indexation in the capital market was discontinued along with the indexation of wages at a time when the general indexation in the economy seemed likely to exacerbate inflationary pressures. The French have found bonds linked to the value of gold to be an extremely costly instrument. But a link with gold, or indeed with the price of any specific commodity, is potentially far more dangerous than a link with prices in general, and is not to be recommended. All in all, foreign experience is not necessarily a good guide to the likely effects in the UK now. In many instances indexed debt has been offered as a defensive measure, to maintain capital market facilities for borrowers when inflation was rapid and rising. A restricted issue in the UK by a Government determined to maintain strict monetary control and at a time of falling inflation would be a quite different proposition.

Conclusion

18. The economic and monetary arguments for indexed gilts are strong. There would be benefits in terms of lower interest rates because of the reduction in uncertainty in the market and, probably, in the demand for money. There would also be a significant gain for monetary control. The presentational problems do not seem insuperable. The key question relates to the effect on expectations. There is no doubt that in some circumstances the impact could be adverse. But at present the decisive influence on expectations should be the Medium Term Financial

Strategy and the determination of the Government which that Strategy embodies. If a decision to issue indexed gilts were viewed as supporting the implementation of the strategy, as it should be, it would be seen as further evidence of the Government's resolve to defeat inflation.