



10 DOWNING STREET

From the Private Secretary

29 January 1981

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Dear Mr,

As you know, the Prime Minister met the Chancellor and the Governor yesterday afternoon to discuss the proposal to introduce an indexed gilt.

The Chancellor said that the basic objective was to achieve a more effective marketing of debt. There were two possible approaches - improving the method of marketing, for example by introducing auctions; and improving the instruments, for example by introducing an indexed gilt. His preference would have been to have concentrated at this stage on improving the methods of marketing; but he understood that the Governor felt unable to make any general move in that direction. That being the case, although he continued to have some residual anxieties about the move to indexation, he believed, on balance, that an indexed gilt should now be introduced.

The Governor said that the Bank could change their methods of selling debt. But this would involve considerable market disruption and would thus interrupt the funding programme; and in their view, the proposed changes in method would raise the cost of borrowing. The present methods had worked remarkably well over the last few years. Enormous amounts of debt had been sold and this had been accomplished relatively smoothly and there had been only a very few funding pauses. If the Bank were to go over to an auction system for conventional stocks and this were to be accompanied by forced selling as some had proposed, gilts prices would become more volatile and less attractive to hold and the market would be irrevocably damaged. Therefore, it was not so much a question of the Bank being able to change their methods: they felt it would be undesirable.

The Governor went on to say that the proposal for an indexed gilt raised some very difficult questions. On the one hand, from a marketing point of view any increase in the variety of stock available was desirable. He understood that the Scott Report on public sector pensions was in favour of an indexed gilt; and it was possible that it would reduce the overall cost of borrowing. If there was to be such an issue, now was the time to introduce it - when inflation was coming down. On the other hand, there was

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the broad politico-economic question of whether it was wise to extend indexation in this way when the Government's whole philosophy was to re-establish nominal money as a store of value. He assumed that Ministers had considered this point carefully. Furthermore, there was likely to be criticism from some quarters that the Government had lost confidence in its ability to fund the seemingly out-of-control Government borrowing requirement. There would also be criticism from corporate borrowers who would never be able to compete with the Government and issue their own indexed debentures. But if Ministers were clear that they would like an indexed gilt, the Bank were prepared to issue one; and as would be necessary, to do so by auction - though possibly with a reserve price. They were considering what should be the amount of the issue; it would probably be in the region of £2 billion.

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The Prime Minister said that she was aware of the arguments against. But she and the Chancellor had concluded that it would be right to announce an indexed gilt - mainly because it would provide some reduction in the cost of borrowing (especially in nominal terms in the early years); and because it would help to fund the borrowing requirement.

Finally, the question of timing was discussed. The Chancellor said that he was not entirely clear how soon an announcement could be made: there was still an outstanding Inland Revenue point to be resolved. On the whole, he felt it would be best to announce it in the Budget, but he did not wish to exclude the possibility of doing so earlier. He would consider this further with the Governor and report back to the Prime Minister.

The Governor emphasised that it was absolutely crucial that the decision to introduce an indexed gilt should not leak: if it did this would immediately cause the market to dry up pending the announcement.

The Prime Minister said that she would be inclined to wait until the Budget, but she would await the Chancellor's further advice.

In view of the Governor's point about the risks of a leak, you will no doubt ensure that knowledge of this decision is kept to as few people as possible.

I am sending a copy of this letter to Tim Allen in the Governor's Office.

Handwritten flourish or signature mark.

Handwritten signature: Tim Allen.

A.J. Wiggins, Esq.,
 H.M. Treasury.