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20.12.79

MR.FFORDE

Copies to: Mr.McMahon
Mr.Dow
The Chief Cashier
Mr.Dicks-Mireaux
Mr.Goodhart
GPS

1) I AGREE WITH DAW'S VIEW THAT THE PENDULUM COULD SWING BACK TO DEBT MANAGEMENT QUITE QUICKLY (PARA. 5) AND THAT WE SHOULD THEREFORE, AS YOU PROPOSE ELSEWHERE, TACKLE THIS QUESTION RIGHT AWAY.

2) I ALSO FEEL WE NEED TO SEE ANDREW BAIN ON GENERAL AND TACTICAL GROUNDS

JMF 21/12

INDEXATION

1. Despite the immediate preoccupation with work on monetary base control, I suggest that it would be timely to take stock of the arguments with respect to indexation of gilts fairly early in the New Year.

3) WILL YOU, JERD + DAW PLEASE THEREFORE SPEAK TO ME ABOUT ATTACHED GROUP OF PAPERS SO THAT WE CAN AGREE, OR CONFIRM ACTION NEEDED OR TAKEN. GR 28/12

2. Many of the considerations are well set out in the recent paper by Andrew Bain and in the comment on it by CAEG. It is not necessary to reiterate them here, but perhaps useful to recall at the outset some of the illustrative arithmetic yielded by JPB's recent exercise. Assuming a gradual fall in the rate of inflation from 17% now to 8% in 1985, and constancy at that level thereafter, the average gross real return on the latest 20-year stock (14%, issued to yield 14.7%) is some 4%, compared with, for example, a negative gross real return of some 1.4% on 4¼% British Electricity 1974/79, purchased 20 years ago. Taking a more optimistic view of the inflation prospect, a long-term inflation rate of 6% after 1985 implies an average gross real return of 5.3% on the latest long-dated stock, and only if the long term inflation rate stays at 14% or above will the gross real return on the latest issue fall below 1%.

3. Apart from the familiar considerations related to long-run cost, two main factors have particular topical relevance:

(a) On the latest financial forecasts, taking account of prospective redemptions, and assuming a maturity structure for new debt similar to that recently, as much as £4 billion of long-term debt may need to be issued

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in 1981/82. Even on an optimistic view of possible interest rate developments, the PSBR cost of this new debt is quite likely to be some £500 million in a full year, with a substantial part falling in 1981/82. If indexed stock were issued with a zero or minimal coupon, the bulk of this would register as a PSBR saving, since revaluation of indexed debt would not be added back to the PSBR. This may be regarded in economic terms as largely presentational, but there remains the substantive point that, to the extent that nominal debt interest is reduced, the central government financing requirement is reduced correspondingly.

(b) After the present preoccupation with monetary base control has abated, attention will inevitably switch back to other hardy annuals such as exchange rate arrangements and techniques of debt management. The pendulum could swing quite quickly. There are live institutional questions with respect to techniques of debt management but, these apart, there is also for consideration whether an experiment in indexation would not be a way of experimenting with an auction or tender issue which we would, for familiar reasons, be unwilling to undertake on a conventional basis.

4. Let me enlarge on the latter. I have doubts about CAEG's view that, for it to be worthwhile, any move toward indexation would have to involve a fairly massive conversion operation. An indexed issue would in my view have to be experimental and, while it would no doubt be necessary at the time of such an issue to give the market some guidance, in very broad terms, as to the future intentions of the authorities, this would not in my view militate against making an indexed issue for, say, £1 billion which manifestly met only part of the

funding need in any financial year. Given that the whole operation would be experimental, with no objective basis on which to determine pricing of an issue in the conventional way, I see no alternative to either a tender or, probably preferably, an outright auction for at least the first of any series of indexed issues. Since the first of such issues would thus be visibly a trial run, with the experimental nature of the operation concentrated on indexation rather than the technique of issue, it seems to me that we could contemplate use of the auction technique with an indexed bond even though the (institutional/market structure) basis for objection to auction of non-indexed stock remained as strong as hitherto.

5. I put this forward now not because I have a decided position on indexation (though I see the arguments in favour to be growing in weight) but because I believe that the pendulum could swing back to focus on debt management quite quickly. It would be a pity for the Bank to find itself unprepared when most of the substantive reservation to indexation may be felt not in the Bank but in government.

6. It may be useful if, against future discussion on all this, I set down a number of specific points on which I suggest that the Bank should seek to reach a view on at least a contingent basis:

(a) To what series should indexation relate? Andrew Bain and CAEG argue rightly in my view against exclusive reliance on the RPI, which would guarantee the real value of debt; but I have a good deal of sympathy for the argument (put by CTT) that the most that the authorities should offer is guaranteed maintenance of real value and that, against the possibility that real earnings will rise, it would be as well to provide for indexation to whatever is the lower of the retail price index and an appropriate earnings index.

(b) It is sometimes suggested that the argument for indexation based on the prospective real cost of servicing non-indexed debt of inflation falls could be met by taxing away the "excessive" gains of investors as inflation falls. This is plainly conceivable, but apart from practical difficulties (would the levy or whatever apply only to gilts?) would plainly attract a good deal of criticism as an effective if not formal breach of the terms of the prospectus: it hardly seems proper or appropriate to plan on the basis of imposing any such charge.

(c) Much would depend on the presentation of any indexed bond that was issued and, from this standpoint if no other, there might be merit in issuing the first indexed gilt on a zero coupon basis.

(d) The fiscal treatment of indexed debt would need early examination. The relaxed view would be that the fiscal bias in favour of indexed gilts would be only marginally greater than the present bias in favour of government debt; but if a different view were taken, it might be important for government to be able to indicate at the time of a first indexed issue what its intentions were in this respect.

7. Political resistance to debt indexation in present circumstances plainly runs deep. The matter is made a good deal more awkward by the efforts currently being made to find ways of de-indexing certain social security benefits. But that the awkwardness here is largely presentational needs little emphasis: an indexation arrangement which offered nothing better than maintenance of capital value for 20 years may turn out to be much less attractive than either non-indexation of government debt (if we are reasonably optimistic about inflation) or than the prospect of real earnings gain for the unemployed (for whom there must remain the likelihood of a substantial amelioration in their lot over the next two decades as a whole, even if immediate maintenance of their present position were no longer formally guaranteed).

7. My concern is that the balance of political and other arguments here may come quite quickly to be seen differently - perhaps first in the public expenditure/PSBR context - and that the Bank should be prepared.

D.A.W.

D.A.Walker

20th December 1979.