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30 August 1983

Copies to GPS
DGPS
Mr Fforde
Mr Plenderleith

Mrs R Lomax
H M Treasury
Parliament Street
London SW1P 3AG

Dear Rachel,

As agreed with Frank Cassell, before he went on leave, I am enclosing a note on indexed gilts which the Chancellor asked should be available for his return.

You will see that we hope that we are near to the point at which we can make specific proposals for action in the indexed sector, but that hope has been set back today by the disturbance to the whole of the gilt market caused by developments in the US over the weekend. This influence may, however, prove to be short-lived.

Yours sincerely,

Eddie.

INDEXED GILTS

1 The Chancellor is anxious to see the indexed gilt market reactivated. So are we: with the pressure currently put on the gilt funding programme we can ill afford to have any major cylinder not firing. This note therefore considers the tactical means of achieving that end.

The recent development of the IG market

2 It is fundamental to understanding the IG market to appreciate that it is still very much in its infancy. Excluding the two shortest maturities (1988 and 1996), the total number of holders of each of the other IGs is no more than about 1,000 (see Table A) and that number is increasing through time only very slowly. Within that number the holdings are very concentrated: the largest 25 holders own some 50% of the total amount of the six conventional IG issues from 2001 to 2016 between them and the largest 100 holders in each stock some 90%. By comparison long-dated conventional stocks have anything up to 20,000 holders. For the time being at least therefore the IG market is inherently very narrow. As a result the demand for IGs is relatively insensitive to real yield variations. What we have seen instead is longish periods of almost complete inactivity in the IG sector interspersed with shortish bursts of demand for IGs (in amounts of £250-500 million), with these bursts typically coming when an upturn in the conventional market appeared to have run out of steam, and with a sizeable proportion of the demand for IGs reflecting switching out of conventional stocks. Once bought IGs tend on the whole to be fairly firmly held, so that the bursts of demand have tended to produce quite sharp falls in real yields even though we have provided stock in these periods (see Chart A). We have not detected any very clear link between the state of demand for IGs and inflationary expectations such as one might expect, but it has to be said that inflationary expectations have been improving steadily through most of the relevant period.

3 Over recent months there was an unusually abrupt reassessment of the IG market generally around the time of the Election - between mid-May and end-July real IG yields rose, on persistent but small

selling against a complete absence of buyers, by ½% at the longer end (and as much as 1% on the 1988 stock) to record high levels (see Chart B). The dominant factor behind this re-rating was undoubtedly the conviction, and subsequent confirmation, that the Government would be returned, and would persist in an anti-inflationary strategy; the fact that this sentiment was not fully reflected in the conventional market is probably explained by the shorter-run uncertainties over US developments and our own monetary/fiscal situation. A subsidiary factor was probably the concern of some large IG investors that pressure to increase the supply of IGs might be stepped up. The Convertible IG issued on 5 May did not help the general IG market climate - though it did, of course, provide useful funding when the market generally was otherwise very difficult, both when it was first issued ahead of the Election run-up, and subsequently in breaking something of a log-jam in banking July. None of this of course explains why real yields generally - both here and in the US - remain as high as they are.

4 Real IG yields stabilised around mid-July. The dribble of selling went away but no real signs of fresh demand emerged, and for some two or three weeks real yields remained on a very high plateau with the market extremely inactive. Since early August we have seen a small demand beginning to re-emerge, and have peddled out some £100 million of conventional IGs from the Issue portfolio. Real yields have gradually receded, and this movement has gathered momentum in the last few days. We have attempted to encourage it by displaying some reluctance to supply in response to bids from the jobbing system with the aim of stimulating a broader investor interest, though this has yet (26 August) to appear. Our holdings of IGs are now totally exhausted.

Possible tactics

5 One possible approach to selling more IGs in the dormant periods would be simply to bump up real IG yields to the point where broader-based demand emerged.

6 No one can know with any certainty what this approach would require in higher yield. But we believe the rise in yields would need to be very considerable to achieve any worth-while short-run effect. This view is based in part on the narrowness of the market at its present

stage (described in paragraph 2 above) and the related price insensitivity of demand. But, in addition to this, deliberate action by the Government to force yields up would, of itself, act to deter investors. Existing IG holders - who have anyway had a miserable experience generally - would see further losses consciously imposed upon them by the authorities; and this message would not be lost on the broader market we were hoping to reach. Investors generally would need to be more than usually confident that yields had reached their peak, and such confidence would be the more difficult to build because the perception would be that what the Government had done once it could just as well do again.

7 The impact of a significant rise in IG yields would not of course be confined to the IG market but would be bound to affect financial markets generally, ie, property and equity yields as well as conventional gilt yields, and, by spreading down the yield curve, probably having some direct effect on shorter-term rates. As a result it could have significant effect on the behaviour of the economy.

8 The effect on the cost of debt servicing is complicated. Looked at in isolation it is clear that the direct effect of bumping up IG yields - and the associated rise in conventional gilt yields - would be adverse. The <u>rise</u> in yields required would be likely in our view to be higher than the rise in yields required to sell an equivalent additional amount of conventional gilts because the conventional market is more highly developed and price sensitive. One might nevertheless take the view that IG funding was likely to prove so much cheaper in real terms than funding through other instruments that there would be a real debt service benefit from a higher proportion of IG funding even with generally higher yields. Ex ante it is impossible to tell. A note on the comparative cost of IG and conventional gilts is attached, which may suggest that this outcome would be unlikely.

9 The Bank would advise very strongly against this approach. An attempt to force the development of IGs in this way would be damaging in our view to long-run investor demand for IGs. It would also cause serious short-run disruption to the financial markets with harmful effects on the economy more generally.

10 The alternative general approach, which we have pursued hitherto, is broadly to attempt to bring the IG market on by feeding IG demand when it emerges. We have not tried to force the pace during the periods in which the IG market has been dormant*, but have been ready to sell IGs and issue new stock quite rapidly in response to an upturn in the market. This can be seen clearly from Chart A which shows that we have issued new IG stock in response to each market rally. Our reaction has not been immediate because we have not wanted to stamp out each market improvement as soon as it appears for the same reasons as in paragraphs 5 to 9 above. This approach has enabled us nevertheless to take advantage of market adjustments pushing yields up without ourselves being seen to have engineered the rise. The very recent improvement in IG prices - even though it has occurred in a very thin market - will hopefully provide the opportunity for a further move within this general approach.

11 There are three main options for such an early further move -

(i) We could attempt to sugar the IG pill with a conversion option.

The 1999 Convertible IG was rather better received by analysts/commentators than investors. It was designed for the particular circumstances of electoral uncertainty. While this, or some variant of it, could be a useful move in the months ahead - particularly if the upturn in the RPI should have an exaggerated effect on inflationary expectations - we do not see it as the immediate next step. The gilt market has for the time being become generally somewhat cautious about unfamiliar instruments, and could well interpret further innovation as desperation in the near term. Moreover, we do not think it will help to develop the underlying IG market if we appear to suggest that IGs can only be sold with some kind of decoration attached.

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*Indeed at times of particular weakness we have supported the IG market in order to preserve the marketability of the stocks when the jobbers - in the absence of buyers - would otherwise have been reluctant to deal.

(ii) We could launch a full-blown (£750 million - £1 billion) new - probably longer than 2016 - IG by public tender with part-payment over two or three months.

This is certainly something that we want to find an opportunity to do as part of the process of extending the maturity range and to take advantage of the downward sloping IG yield curve. To launch successfully, however, it will require more substantial IG demand generally than we have so far seen in the recent rally: otherwise we would be likely simply to turn the whole IG market off. But it is a possibility if the current improvement gathers momentum.

(iii) We could place in the Issue Department a package of IG tranchettes (specifically adding to the 2001, 2003 and 2009 maturities all of which are presently very small issues of either £250 million or £400 million).

The particular purpose of this option would be to increase the marketability of these very small issues. It is primarily because the jobbers have been unable to obtain any significant amounts of these stocks that the IG price rise in the last few days has been exaggerated. Making modest amounts (£50 million - £100 million) of them available now could persuade investors who might have been interested in lumpier amounts to bid for them while they are still available in size, though it is also likely that (smaller) shorter-term holders who have recently bought on the technical shortage of stock would be shaken out.

In deciding between options (ii) and (iii) we will need to take account not only of the state of demand in the IG market, but also of the buoyancy of the gilt market as a whole. We could destroy the present encouraging undertone by appearing to oversupply the market with stock at a sensitive moment when we may have the prospect of reactivating the short market on some scale, and selling some of the latest conventional tranchettes.

Against that background we hope - and always assuming that the IG market remains at least moderately firm - to be able to bring forward specific proposals for reactivating the IG funding programme during

the course of the next few days. Our present expectation would be that it is more likely that we would wish to recommend tranchettes - as a first step, looking to follow this up with a new longer-dated IG as soon as the opportunity presented itself. But, if both the conventional and the IG markets move more strongly ahead, we could opt for the new stock as the first move.

With this kind of tactical approach we would hope to be able to continue increasing gradually the volume of IG issues. But it would be wrong to suggest that this will be other than a very hard slog so long as the markets retain their fundamental confidence in Government policies.

TABLE A

NUMBER OF HOLDINGS OF INDEX-LINKED STOCKS

Maturity	Nominal amount outstanding (£ million)	Number of holdings[a]				
		Early Oct 82	Mid-Nov 82	Mid-Feb 83	Mid-May 83	Mid-Aug 83
1988	750[b]	10,800 (8,800)	13,400 (10,700)	21,000 (15,800)	24,900 (18,200)	25,300 (18,300)
1996	1,000	2,100 (900)	2,300 (1,000)	3,600 (1,900)	4,400 (2,600)	4,400 (2,700)
2001	250	(c)	700 (500)	1,000 (700)	1,100 (800)	1,200 (900)
2003	250	-	(c)	800 (500)	900 (600)	900 (600)
2006	1,000	900 (300)	900 (300)	1,000 (400)	1,000 (400)	900 (400)
2009	400	-	200 (-)	400 (100)	400 (100)	400 (100)
2011	750	800 (200)	800 (200)	800 (200)	800 (300)	700 (200)
2016	750	-	-	(d)	900 (500)	900 (500)
1999	1,000					1,330 (900)

Note: No figures are available for the 1999 convertible stock because it was still in allotment letter form at mid-May.

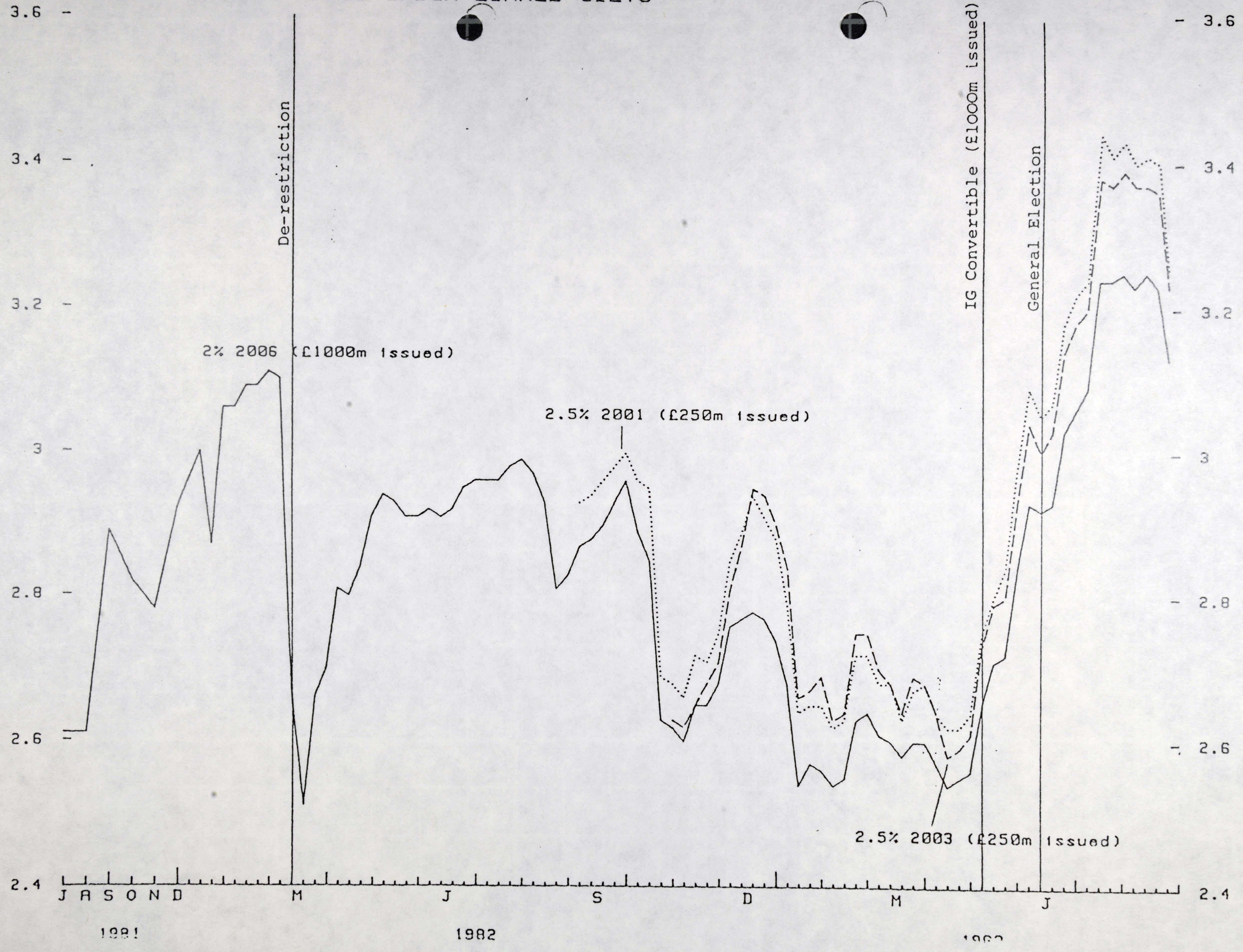
(a) The figures in brackets show the number of holdings identified as holdings of private funds and private trusts. All figures are rounded to the nearest hundred.

(b) The amount of the 1988 stock outstanding was increased to 1,000 million in December 1982.

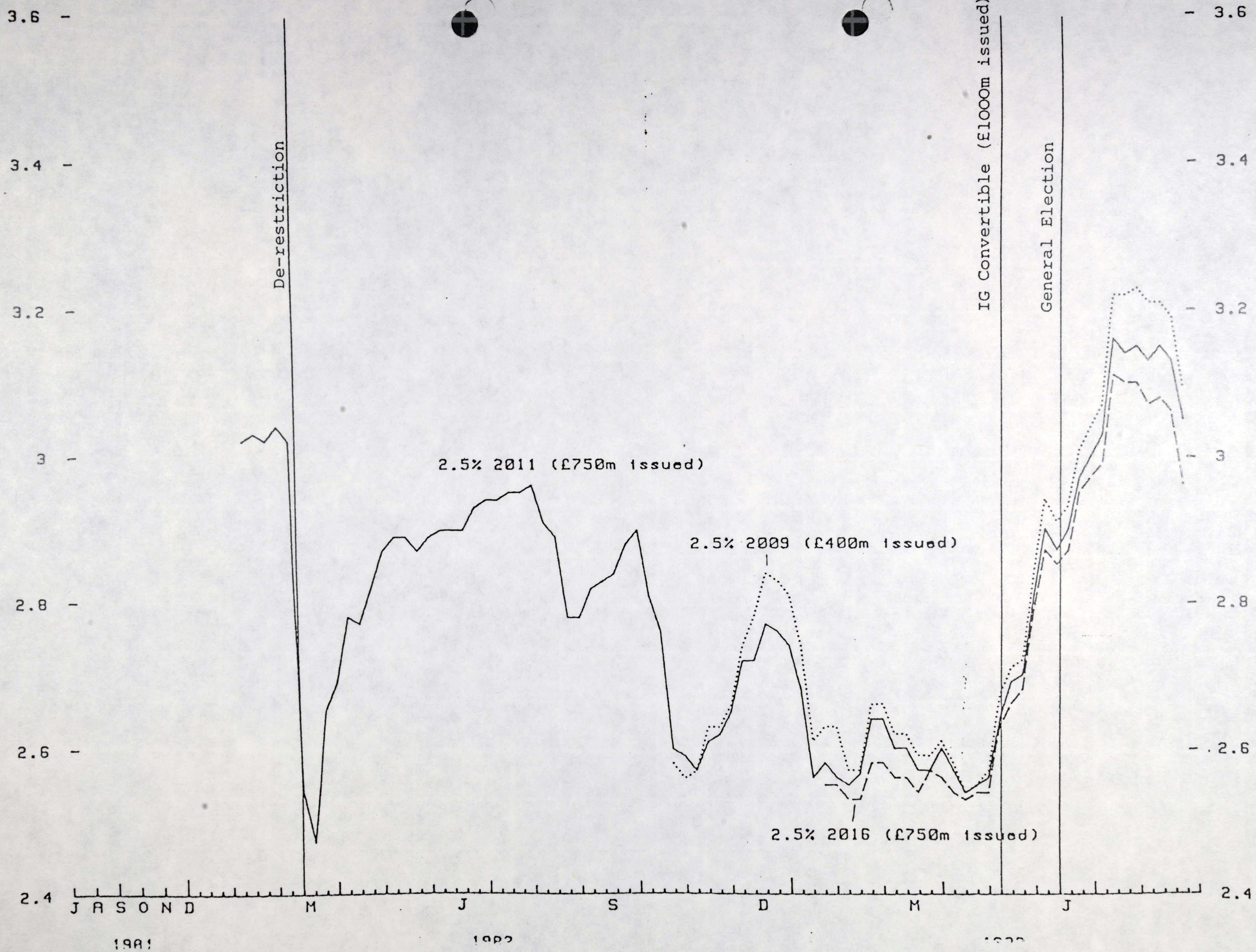
(c) Official holdings not exhausted.

(d) No figure quoted because the stock was still in allotment letter form.

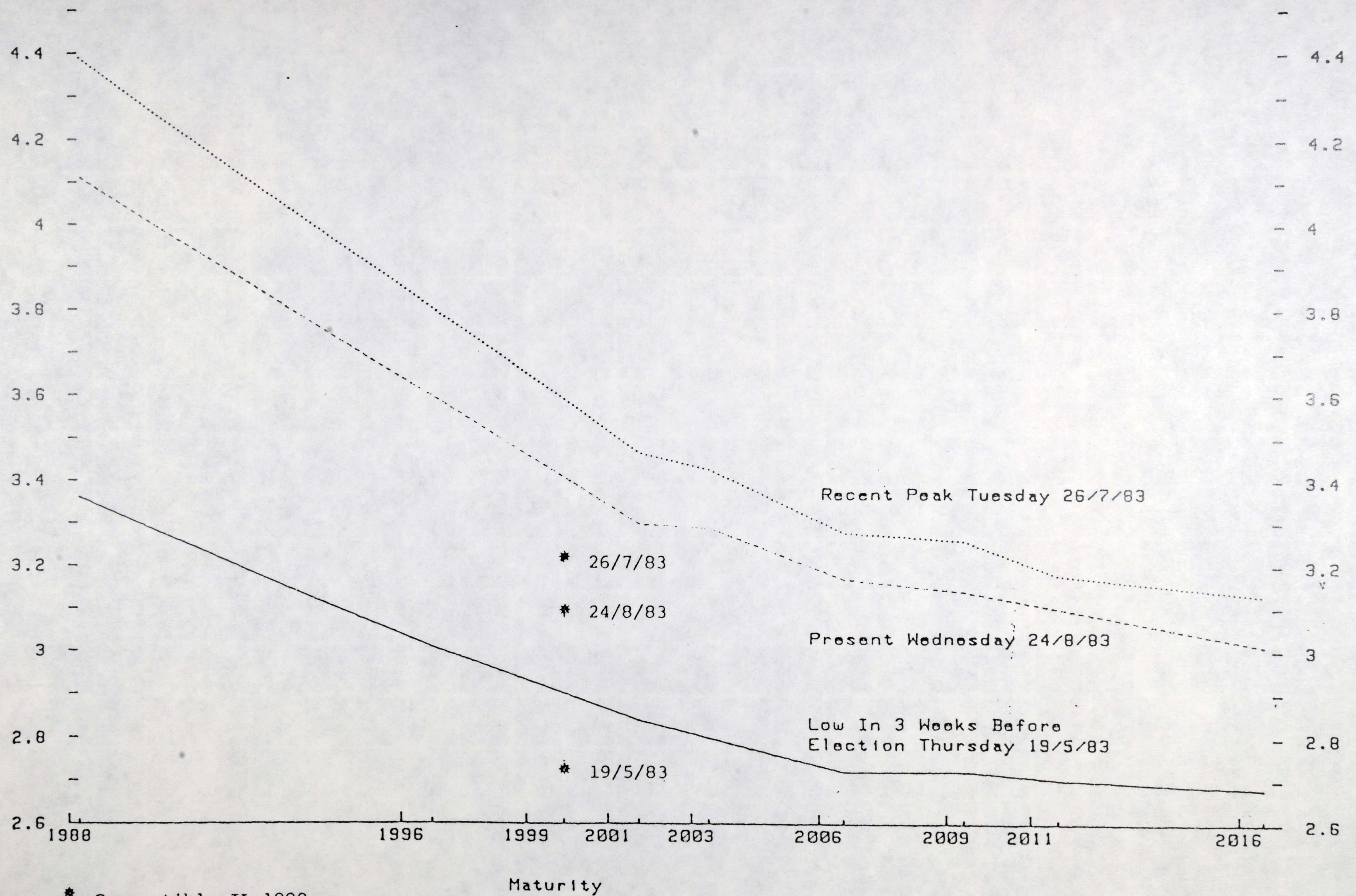
YIELDS ON LONG-DATED INDEX-LINKED GILTS



YIELDS ON LONG-DATED INDEX-LINKED GILTS



Real Yields Curves For Index Linked Stocks CHART B



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The relative costs of IGs and conventional debt

1 Any assessment of the relative costs of IGs and conventional gilts depends on the assumptions made. The attached table shows a range of possible outcomes [in terms of the present value of net saving (+) or cost (-) achieved by issuing £1,000 of 20 year IG rather than 20 year conventional debt] on various assumptions about -

(i) the future rate of inflation;

(ii) the effective rate of tax paid by holders of gilts; and

(iii) alternative issue terms.

2 As far as the inflation assumptions are concerned obviously the lower the future rate of inflation the more favourable, ceteris paribus, the outcome for IGs. But for a period as long as 20 years the future rate of inflation must be a matter of hunch. All three illustrative assumptions - average inflation of 3%, 5% and 7% - reflect some degree of inflation optimism compared with recent past experience. Inflation can scarcely be much lower than the lowest (3%) rate assumed. There must be some greater risk that it will be higher than the highest (7%) rate assumed, and in this sense the assumptions are perhaps asymmetrical.

3 As far as the tax assumptions are concerned, again, the lower the effective tax rate on conventional gilts the more favourable the outcome for IGs. In practice we have no very clear idea of what the effective tax rate is. We have attempted to quantify it both by applying appropriate tax rates to different categories of holder and by examining the "coupon effect" observable in the conventional gilts market. The evidence is not conclusive but suggests that the alternative assumptions of 0% and 30% shown in the table for the effective tax rate are the likely extreme ends of the range of possibilities, with the simple weighted average rate under the first approach just above the mid-point of the range.

4 Finally, the issue terms have been assumed initially to be broadly in line with present yields. The IG yield is then varied simply in order to illustrate the sensitivity of the calculations to this factor. In practice, as noted in the text, we do not know what change in IG yields would be required to sell significantly more IGs; and it is likely that conventional yields would also rise in that case.

RELATIVE COSTS OF IGS AND CONVENTIONAL DEBT

Present value in £ of net saving (+) or cost (-) from issuing IGs rather than conventional gilts

	1 Current yield basis (ie IGs at 3% real yield; conventional stock at 11% nominal yield)			2 Higher IG yield (ie IGs at 4% real yield; conventional stock at 11% nominal yield)		
	Inflation assumption			Inflation assumption		
Income tax assumption	3%	5%	7%	3%	5%	7%
0%	+570	+290	+ 90	+420	+150	- 60
30%	+200	- 40	-220	+110	-140	-320

The figures quoted give the present value in £ of the net saving (+) or cost (-) of issuing £1,000 of 20 year IGs rather than 20 year conventional gilts. In each case it is assumed that net dividends on conventional stock are reinvested at a nominal 3% pa above the rate of inflation and that dividends on indexed stock are reinvested at a real yield of 3% pa.