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CHANCELLOR'S 1988 PAPERS
ON THE NATIONAL LOTTERY

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FROM: D L C PERETZ
DATE: 14 September 1988

1. ECONOMIC SECRETARY *See note below APS/EST 15/9*

2. CHANCELLOR OF THE EXCHEQUER

cc: Chief Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Odling-Smee
Mrs Lomax
Mr Grice
Miss O'Mara
Mr Gieve
Mr Ritchie
Mr Rich
Mr Cropper
Mr Tyrie

File: MAMC W1

*I think Joe Grice's note is slightly overstated (i) the Greenwell's/Kleenwort thesis is that DNS takes cash from persons possibly limiting their spending (ii) if B. Socs made good those funds from the wholesale markets that would come from institutions (iii) the B. Socs may not automatically borrow as much from the wholesale markets as they would have received from persons absent large DNS borrowing. Put another way B Socs lending may in the short term be driven by the level of deposits. (iv) DNS instruments (i.e. National Savings Certificates) are less liquid than B Soc deposits. In general their argument is that when you pour honey it takes time to spread out, at first the honey is thicker where it is poured. PPD 14/9*

## NATIONAL SAVINGS

You asked for a note on National Savings rates (Mr Allan's minute of 9 September). I am also taking the opportunity to attach a note by Mr Grice and myself concentrating on recent suggestions in brokers' circulars that we should be funding more aggressively through National Savings. One of these is Greenwell's proposal which the Economic Secretary mentioned yesterday.

2. You will recall that when we discussed the recommendations in my minute of 24 August, you decided that there should be an early rise in the three main DNS variable interest rates, but that no other changes were needed for the time being. We announced rises of 1¾ per cent for Income and Deposit Bonds, and 1½ per cent for Invac, on 26 August. How do things look now?

### Competing retail interest rates

3. The attached table shows the pattern of retail interest rates we are now expecting, once building societies have moved their rates on 1 October. The large banks have already raised their high interest retail deposit rates to an average of 8.2 per cent, a little below the new 8.4 per cent Income Bond rate, for a standard rate taxpayer; the building societies seem likely to

move to a slightly higher average rate, around 8½ per cent. (Of course, some individual banks and building societies will offer higher rates than these, and others lower).

4. Much depends on what societies decide on **mortgage rates.** Despite the Barclays move to 13 per cent, we still think a general rise of only 1¼ per cent, to 12¾ per cent, is likely - and on this basis would still expect a ¾ per cent rise in average deposit rates, to 8½ per cent. Halifax and Abbey National have indicated they will be moving on 1 October. Barclay's previous rate was around ¼ per cent above building society rates, and they may be aiming to hold that kind of differential. And the view of experts in the BSA is that the societies are currently paying more attention to competition from new mortgage lenders than the banks: so Household Mortgage Corporation's move to 12.85 per cent and the Mortgage Corporation's move to 12.65 per cent may be more significant.

5. This last point adds force to the view that building society mortgage rates are mainly influenced nowadays by movements in wholesale market rates (which both represent their marginal cost of funds, and affect their most feared competitors), rather than movements in competing retail rates such as National Savings rates.

**National Savings Rates**

6. For this and other reasons, more fully set out in the attached note, I do not believe further changes in National Savings rates now would be likely to affect building society decisions one way or another; nor do I think we want to make any of the rates on National Savings liquid instruments super-competitive.

7. National Savings flows are now very small in relation to building society inflows. But even if we induced multiple expansion of inflows into National Savings there would probably be no effect on mortgage lending or mortgage rates. We would either have to return to overfunding (for which there are few arguments: see my minute of 1 July); or increase our gilt purchases. In either case we would, in effect, simply recycle National Savings

money into the wholesale market - which societies now see as their marginal source of funds, and which is the main influence on the rates set by the competitors (the new mortgage lenders) they fear most.

8. As the attached note suggests, this does not mean there is no contribution that National Savings, and funding policy more generally, can make, given current policy concerns. There are two possibilities, though neither applies across the board to all National Savings instruments, or to all wholesale funding instruments either:

- first, if we can tap new savings markets, not already exploited by others, we might be able to raise overall saving in the economy for a given level of interest rates. If the new Capital Bond is a success, it might turn out to have this effect

- second, within the funding rule we can take further action to reduce the liquidity in the economy by buying in/running off the more liquid forms of government debt (this includes several National Savings products as well as very short gilts and CTDs), and replacing them with less liquid debt (5 year gilts, Capital Bond, etc).

<u>Conclusion</u>

9. On this analysis:

(i) it is important to have a successful launch for the Capital Bond;

(ii) I would not want to raise interest rates on Income Bond/ Deposit Bond/Invac any further. The figures suggest we got these about right on 26 August. They are high enough to rebut accusations of bad faith - particularly for the Income Bond, where the main sensitivity is;

(iii) there is a case for stepping up buying in very short gilts as well as longs;

Scarcely an increase in savings — only as a counterpart of higher inflows from DNS.

NBL

(iv) there are arguments for and against introducing a new 35th Issue Fixed Interest Savings Certificate. On a comparison with the cost of 5 year gilts, we could introduce a new certificate with an 8 or 8¼ per cent coupon. But, the current certificate has been on sale only since July; is bringing in a reasonably healthy £40 million a week; and we doubt whether a new certificate now would bring in much more, other than some initial rush of £1000 maximum investments by high rate taxpayers. This would be high cost funding and seems unlikely to represent additional saving in the economy.

J. W. Grice

pp D L C PERETZ

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**NATIONAL SAVINGS RATES AGAINST BANK AND BUILDING SOCIETY RATES**

Per cent

| | Tax Rate | | |
|---|---|---|---|
| | **0** | **25** | **40** |
| **National Savings** | | | |
| Income Bond[1][2] | 11.2 | 8.4 | 6.7 |
| Investment Account | 10.0 | 7.5 | 6.0 |
| Savings Certificates | 7.5 | 7.5 | 7.5 |
| **Bank Retail Deposits** | 8.2 | 8.2 | 6.4 |
| **Building Society Retail Deposits**[3] | 8.5 | 8.5 | 6.6 |

**Notes**

(1) Assuming interest re-invested in Investment Account

(2) From 9 October

(3) Assuming an increase of ¾ per cent on 1 October

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**MORE AGGRESSIVE NATIONAL SAVINGS?**

Given the need to raise interest rates in recent weeks in order to keep monetary conditions on track, there has not surprisingly been a spate of financial commentary proposing other policy initiatives to restrain demand. Predictably much of the discussion has concerned the reintroduction of credit controls as an alternative to higher interest rates. But a few commentators have suggested a more aggressive use of National Savings or, indeed, a more general return to overfunding as appropriate policy measures.

2. This note comments on two typical proposals:

- a piece by Greenwell Montagu, "National Savings: A Cure for Overheating" (30 August), which calls for a "policy reversal", "drawing at least £2 billion into National Savings"

- one by Kleinwort Benson (Gilt-edged Monitor, Market View, 1 September) noting that boosting National Savings would lead to overfunding but arguing that, in any case, a return to overfunding would be apposite.

3. Examination of these articles suggests that in each case the analysis is flawed. But the question remains whether there is any contribution that National Savings or funding policy can make given current policy concerns. This is discussed in the final section of the note.

**The Proposals**

4. Greenwells article (Attachment 1) argues as follows:

(i) an important factor fuelling the present consumer boom has been the Government's policy towards National Savings. National Savings used to finance up to £3 billion of the PSBR each year but on present trends there will be no net contribution this year (our current forecast is actually £1½ billion);

(ii) this policy means that an opportunity to drain

funds from the economy has been lost. In particular, people have been putting money into liquid building society assets - which can easily be spent - rather than saving with National Savings. This trend is sharpened by the fact that this year, for the first time for some years, the personal sector will need to make little provision to purchase privatisation issues;

(iii) changing the National Savings stance - so that it provides at least £2 billion towards financing the PSBR in the current financial year - would remove funds from the personal sector. Either it would draw off money which would otherwise be spent or it would lead to withdrawals from building societies, forcing a rise in deposit and mortgage rates. Both would be desirable outcomes.

5. Greenwells are silent as to whether their proposal would imply overfunding of the PSBR or whether steps should be taken to offset the increased funding from National Savings by defunding in other instruments. Kleinworts (Attachment 2), by contrast, are quite explicit. They see advantage in boosting National Savings receipts and accept that it would imply over-funding. But they welcome that and advocate over-funding more generally - by increased gilt sales, for example - as a way of reducing private sector liquidity.

**The Difficulties**

6. Both of these articles are open to a number of criticisms, quite apart from the fact that Greenwells - without knowledge of the Capital Bond - are calling for little more National Savings contribution than we ourselves expect:

(a) both ignore the fact that the reduced contribution of National Savings to financing the PSBR is the counterpart to a sea-change in the public sector's need for finance. Whilst, for example, National Savings financed the PSBR to the tune of £3¼ billion in 1983-84, the PSBR itself in that year was some £9¾ billion. The swing to a substantial public sector surplus itself acts to drain money from the system, with public sector receipts comfortably exceeding outgoings.

By contrast, when National Savings were attracting comparatively heavy inflows, the public sector deficit was injecting money into the economy, which it was necessary to "fund", to prevent an increase in liquidity. It makes little sense to consider National Savings receipts in isolation without reference to what needs to be financed;

(b) this failure to look at the government accounts overall constitutes a more general criticism of the two articles. Assuming that the full fund rule were maintained, then taking in more National Savings would mean selling less (or buying back more) gilts. It is by no means clear that the result would be less private sector liquidity: on the contrary, if the gilts were less liquid than the National Savings products involved then the reverse would be true;

(c) alternatively, if the full fund rule were relaxed, the counterpart to the overfunding would be an equal and offsetting increase in Bank of England assistance to the money markets. Nowadays building societies - at least the larger ones who account for the bulk of lending - make free use of the wholesale markets, as the banks have for many years. In effect, overfunding would entail the Bank of England's supplying the funds for these wholesale deposits. There might be some switch in business away from the smaller building societies, who have restricted access to the wholesale markets, towards banks and the new mortgage institutions which rely exclusively on wholesale funding. But there is no reason to suppose that it would result in less mortgage lending overall. There are, of course, a number of other objections to overfunding, not least that it is distortionary and liable over time to be expensive for the government. These objectives led us to abandon the policy in 1985 and it is hard to find grounds for reversing the decision in present circumstances;

(d) it is difficult to substantiate the proposition that the decline in National Savings inflows explains any significant pat of the accelerating inflows into building societies. Greenwells argue that it has and cite their table 1 in support. But the following table, which reproduces the relevant parts, suggests that this is by no means obvious.

**Net Inflows of Savings**

£mn, monthly averages, excluding accrued interest

| | | Building Societies | National Savings |
|---|---|---|---|
| 1987 | Q1 | 458 | 157 |
| | Q2 | 601 | 41 |
| | Q3 | 404 | - 25 |
| | Q4 | 1002 | -114 |
| 1988 | Q1 | 1017 | 89 |
| | Q2 | 1391 | - 48 |
| | July | 1362 | n/a |

Between the second quarter of 1988 and the same quarter of the preceding year, new money inflows into building societies increased by over £750 million a month. Over this same period, National Savings inflows declined by less than £100 million. The key point here is that National Savings flows are small nowadays in relation to building society inflows. To have any significant effect on retail flows into buildings societies a very substantial increase in National Savings would be required. Even then, for the reasons given in (c) above, it is doubtful if there would be much impact on total mortgage finance once wholesale funding is taken into account.

**What could Policy on National Savings or Funding achieve**

7. Despite these obvious flaws in the Greenwells/Kleinworts analysis, there are some things we might be able to achieved through the use of National Savings and funding policy more generally.

8. First, it is generally thought that movements in National Savings rates can have a signalling effect, thereby influencing building society decisions. Building societies may have memories of the past when National Savings flows were much more substantial, and therefore pay particular attention to National Savings interest rate moves. But given that wholesale borrowing is now the marginal form of finance for the major societies, the significance of the signal may have changed. The societies are

likely to be concerned by moves on National Savings only if they are perceived to be harbingers of higher interest rates generally. Measures which curtailed their retail inflows wihtout affecting their cost of wholesale funding would not concern them unduly

9. Second, there may be something in the argument that the large retail privatisation issues tapped a new source saving, and raised overall savings in the economy for a given level of interest rates. .It is possible that some National Savings products could have the same effect. The new Capital Bond,for example, will offer a form of saving for which there is no obvious existing private sector analogue - so it may attract some new saving, as well as diverting flows from other savings media.

10. Third, there is scope within the funding rule for increasing or reducing the liquidity of outstanding Government debt. We have been keen to use the opportunity of a PSDR not just to repay expensive debt, but also to repay particularly liquid debt. For example:

(i) we have been seeking to reduce the outstanding stock of CTDs;

(ii) we have, similarly, been seeking to run down the volume of National Savings certificates held on general extension (GER) terms;

(iii) As far as can be done without damaging the long term credibility of National Savings or breaking good faith with depositors, we have been seeking to avoid offering more than adequate interest rates on the main DNS variable rate products (Income bond, Deposit bond, and Invac) all of which are very liquid.

If the funding arithmetic gives us scope to do so, we might also consider:

(iv) additional buying in of very short gilts. Over the next 3½ years some £33½ billion of gilts are due to mature, and these are very liquid instruments.

11. This does not run counter to our strategy of seeking to refinance longer dated debt with shorter dated debt on cost grounds. Even if it did, the cost might be a price worth paying. But in fact, given the need to keep higher interest rates for a while to bear down on inflation, the decline in nominal interest rates implied by MTFS projections will be delayed for a few years. In these circumstances, and given the current shape of the yield curve, refinancing liquid debt with 5 year fixed interest gilts or National Savings products should not be costly, and could even be marginally beneficial.

ATTACHMENT 1

# National Savings: A Cure for Overheating

*Mike Higgins / Michael Saunders / Simon Briscoe*

**Last week's trade figures underlined the contribution of buoyant consumer demand to economic growth. This article analyses two factors which have helped to fuel the consumer boom, but which have largely been ignored.** The first is the changed nature of the Government's privatisation programme in respect of its demands on the personal sector. The second is the policy of the Government towards National Savings since the PSBR went into surplus.

The combined effect of these factors when investment in unit trusts is sharply down in the wake of the stockmarket crash, has been to flood the building societies with cash, with all the attendant impact on credit growth, mortgage lending and, through the suppression of mortgage rates, consumer spending. **An obvious response is for the Government to reverse its policy on National Savings and quickly draw, say, £2bn or more out of the personal sector. Because this would be directly targetted at the over-extended source of aggregate demand, it would be more effective than yet more increases in base rates.**

**Privatisation Programme**

It is well known that the privatisation programme has gained momentum in the 1980s. Last year, over £5bn was netted by the Government. However, this total conceals a great variety of components. In particular, different issues have been directed at different targets: the personal sector, financial institutions or the corporate sector.

The personal sector has spent an increasing amount on privatisations over the years, which largely reflects the sales of BT, BG, BA and BAA, and their attractiveness to private investors. Of the £5bn received by the Government last year, the largest proportion came from the personal sector. Despite many investors subsequently selling their shares, probably £2bn from the personal sector is still tied up in last year's purchases. The personal sector has become accustomed to spending around 1% of its earnings on privatisation issues.

**Recently and in the near future, however, only negligible sums are expected to be paid out by the personal sector in this way.** On a one to two year horizon, the majority of the Government's proceeds will come from companies or financial institutions: Girobank, Rover, British Steel are perfect examples of privatisations that are not targetted at individuals. It is, of course, possible that the buyers of these issues will draw in extra funds from the personal sector to do so, perhaps by rights issues. **But it is most likely that, for the first time in many years, the personal sector will not be making any provision for privatisations.**

The importance of privatisations to the personal sector's finances is exemplified by BP. If the stockmarket crash had not occurred, and if the BP flotation had successfully attracted individuals, the personal sector would have had to find up to £1bn for this week's second instalment. This would undoubtedly have helped to take some of the froth out of the consumer boom.

**National Savings**

Since the stockmarket crash there has been a marked change in the pattern of personal sector savings. This is characterised by a shift away from investment in equity markets e.g. in unit trusts. It is in strong contrast with the first three quarters of 1987 when the booming equity market drew increasing amounts of funds away from building societies. The recent reversal would normally be expected to benefit both building societies and National Savings, as safe havens when the equity markets are not performing well. However, instead of seeking further inflows of money to National Savings, the Government now appears to be allowing net withdrawals of savings.

Until 1986/87 National Savings had a target of providing £3bn a year to financing the PSBR. Allowing for accrued interest (about £2bn a year) this meant net receipts of new savings from the personal sector of about £1bn a year. During 1987/88 net receipts of new savings fell to about zero, so that the contribution towards PSBR financing was down to about £2bn, the amount of accrued interest. The Government is now running a budget surplus, and no target for National Savings has been set for this year. If one assumes, not unreasonably, that the authorities are aiming for National Savings to make a zero contribution towards PSBR financing this year, then with accrued interest of about £2bn, this implies that a net outflow of £2bn from National Savings is required.

With no need for new borrowing, the official National Savings policy objective is now to improve the "quality" of the debt, by decreasing the amount that is likely to be quickly withdrawn if building society rates rise. The authorities' attitude is demonstrated by the reduction of the General Extension Rate on mature certificates (to 5.01% p.a.), and the relatively unfavourable terms of the new 34th issue (yielding 7.5% tax free or 10% grossed up at the basic rate, with a maximum holding of £1,000). These have contributed to substantial net outflows from National Savings Certificates. In addition, rates on the floating rate products have been allowed to lag behind building society rates. The NSB Investment Account yielded 8.5% gross and Income/Deposit Bonds were at 9% gross before the last base rate rise. By comparison, many building societies offered rates between 8.25% and 8.8% net (11 - 11.7% gross equivalent at the basic rate).

**The policy on National Savings has certainly contributed to the flood of personal sector savings into building societies and banks,** as shown by Table I. No doubt, the stockmarket crash was the most important reason for this but changing privatisation patterns and National Savings policy have surely been significant.

**Table I - Net Inflows of Savings**
£m, monthly average

| | | Building Societies | Unit Trusts | National Savings |
|---|---|---|---|---|
| 1987 | Q1 | 458 | 575 | 157 |
| | Q2 | 601 | 411 | 41 |
| | Q3 | 404 | 994 | -25 |
| | Q4 | 1002 | 129 | -114 |
| 1988 | Q1 | 1017 | 119 | +89 |
| | Q2 | 1391 | 139 | -48 |
| | July | 1362 | 111 | n.a. |

Excludes accrued interest
Source: Building Societies Association, Unit Trust Association, Financial Statistics.

## Implications

It might seem that the location of personal savings is irrelevant so far as consumers' total expenditure is concerned. This is not the case. Firstly, savings in interest-paying bank accounts or building societies are more liquid than those tied up in National Savings Certificates. Secondly, and rather more importantly, is the effect on building societies of the influx of retail deposits. The bulk of these inflows have been recycled in increased mortgage lending, enabling building societies to exceed their informal target of a 60% market share, as shown in Table II. **The flows shown in Table I have limited the extent to which building societies have had to raise deposit rates, and hence mortgage rates, in order to meet the exceptionally high level of advances this year and particularly in August.**

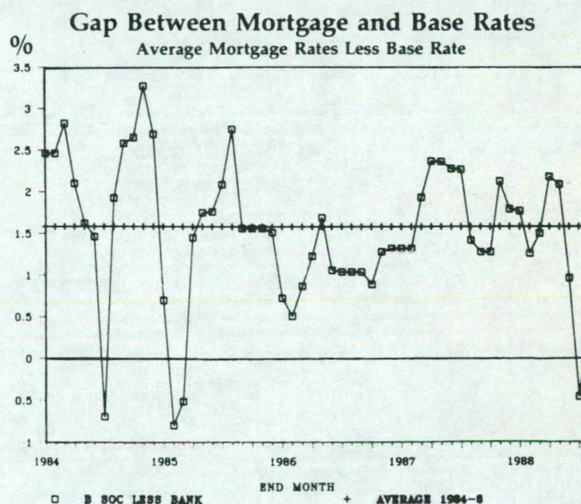
**Table - II Bank and Building Society Home Lending**
Net Mortgage Advances (Monthly Average)

| | | Building Societies £m | Building Societies (% share) | All Banks £m | All Banks (% share) |
|---|---|---|---|---|---|
| 1987 | Q1 | 1170 | (61.8) | 471 | (24.8) |
| | Q2 | 1282 | (53.8) | 806 | (33.8) |
| | Q3 | 1288 | (46.4) | 1061 | (38.5) |
| | Q4 | 1390 | (48.4) | 1029 | (34.9) |
| 1988 | Q1 | 1686 | (60.0) | 734 | (26.2) |
| | Q2 | 2160 | (n.a) | 887(1) | (n.a) |
| | July | 2806 | (n.a) | (n.a) | (n.a) |

Includes Bridging Finance
(1) Monthly average for 3 months to end May.
Source: Building Societies Association, Financial Statistics, Bank of England.

Chart I shows the gap in percentage points between the building societies' average mortgage rates and banks' base rates up until last week's base rate rise. This shows that the gap, until last Thursday's rise, was about 0.4%, the smallest for three years and compares to a more typical gap of 1.25-1.5%. Because retail funds have been flowing in so strongly, for reasons other than the attractiveness of the interest rate, deposit rates have not needed to rise in line with banks' base rates and hence mortgage rates have also lagged behind.

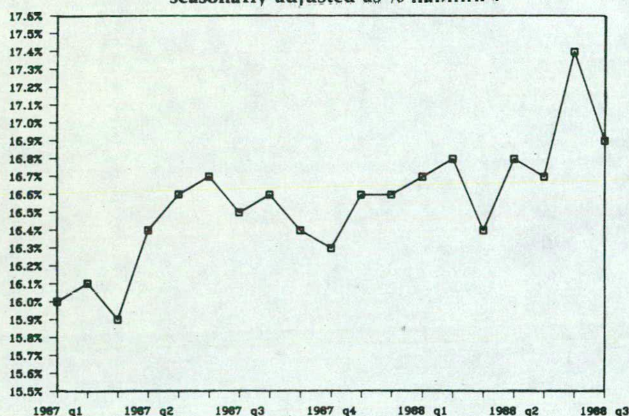
**CHART I**
**Gap Between Mortgage and Base Rates**



**This is important because an increase in building society mortgage rates is one of the most direct ways in which higher interest rates exert a dampening effect on consumer demand.** A one point rise in building society mortgage rates raises after-tax mortgage payments by some £1bn p.a., or 0.4% of total personal disposable income. Before the last base rate rise we had already seen building society rates rise by about 1.75 percentage points at the start of August, which will take about £1.75bn p.a. out of the personal sector in increased mortgage payments. The initial reactions of building societies to last week's base rate rise suggest that a further rise of 1-1.25 percentage points can now be expected, raising mortgage payments by £1-1.25bn pa. Of course, building society deposit rates will also rise and this increases the interest receipts of depositors by only slightly less, but this redistribution of incomes from high spending borrowers to more thrifty depositors reduces overall spending. Another factor is that by restraining the rise in house prices, higher mortgage rates reduce the rate at which home owners feel their wealth increases, hence lessening their willingness to finance increased consumption by withdrawing equity from the housing market.

Another effect of the inflow of funds is that building societies have been able to undertake record lending without reducing their holdings of liquid assets, indeed they have been able to increase their liquidity slightly. This extra liquidity has largely flowed into Sterling Certificates of Deposit, as societies have continued to run down their holdings of gilts. Chart II shows the average liquidity ratios of building societies. This shows that liquidity ratios have risen steadily since the equity market crash, although they fell slightly in July as mortgage lending increased. Building Societies thus have a cushion of liquidity, and could tolerate a fall in liquidity by £1bn or so (to 16.3%) in order to meet the advances due in August.

**CHART II**
**Building Society Liquidity Ratios**
**seasonally adjusted as % liabilities**




Building societies have also not needed to make full use of their greater freedom to borrow money on the wholesale money markets. Prior to 1 January 1988, they were only allowed to raise funds equivalent to 20% of their liabilities by wholesale borrowing, a constraint that began to bite towards the end of 1987. Since then, the limit has been set at 40%, providing them with extra capacity for obtaining funds in his way. Wholesale funding of £600m per month had been expected during 1988, but the outcome so far has been below £450m per month, principally because it is more expensive and retail inflows have been so high.

With inflows at such high levels and no reason for them to slow, and the prospect of lower mortgage demand coming during the autumn, building societies are under no immediate pressure to raise their deposit rates, and hence mortgage rates, by much more than the rise in base rates. **The early indications are that mortgage rates will rise by 1-1 1/4%, so that the differential with base rates will still be only around 0.5-0.7%. This reduces the effectiveness of the most recent rises in base rates in restraining consumer demand.**

Policy Response

**Given the changes in the allocation of personal sector savings, the Government would, in retrospect, have been wise to absorb more of the total into National Savings. Instead they have done the reverse. They should now undo their latest policy and aim to draw at least £2bn into National Savings.** This money would either be money that would otherwise be spent, in which case the growth of consumers' expenditure would slow, or it would come from building societies. In the latter case the outflow of savings, and consequent fall in liquidity ratios, would require them to seek additional funds through either increasing deposit rates on retail accounts or increasing their borrowings on the wholesale market. If deposit rates were to rise, then mortgage rates would need to rise further also. Increased wholesale borrowing would also put pressure on mortgage rates, in order to provide a sufficient margin over wholesale rates.

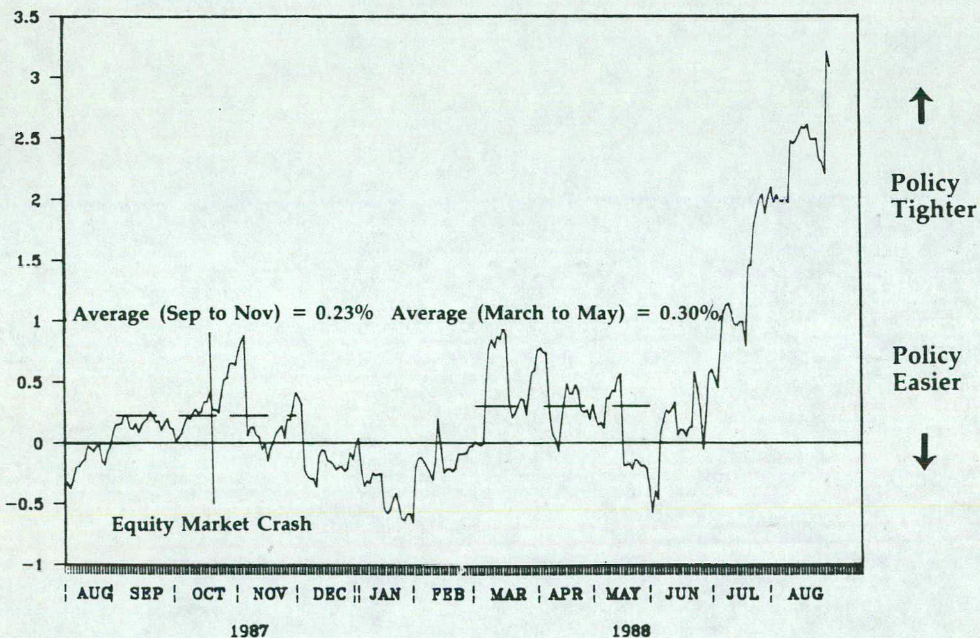
One way of attracting funds into National Savings would be to increase the relatively low ceiling on maximum holdings of the new 34th issue, from £1,000 to, say, £10,000.

This has been done in the past to induce extra inflows, but is only really effective if the current interest rate on the fixed interest certificates is competitive against other interest bearing accounts for basic rate tax payers. The 34th issue yields 7.5% tax free (10% gross equivalent at the basic rate) and is now extremely unattractive for all investors except for higher rate tax payers, and investors expecting deposit rates to fall substantially. Hence, this option would be unlikely to succeed. Another option would be to increase the interest rates on the floating rate National Savings products - the NSB Investment Account, Income Bonds and Deposit Bonds - to attract basic and higher rate tax payers out of building societies.

**Perhaps the best alternative would be to acknowledge that the rise in interest rates has made the 34th issue highly uncompetitive, and issue a new fixed interest certificate** with a higher yield, 9.75% or even 10.25% tax free (13.00 - 13.67% gross equivalent at the basic rate) and with a relatively generous maximum holding (say £5,000 - £10,000). **The Government should aim to offer a higher return for basic rate taxpayers than can be obtained elsewhere, and should aggressively advertise that it is doing so.**

**Conclusion**

The stock market crash, the nature of the privatisation programme in the current year, and the policy on National Savings have all indirectly boosted the growth of consumers' expenditure. **The Government has an opportunity with National Savings to drain more personal sector funds out of the system. This would be an effective way of reducing the overheating in the economy and can be implemented with great ease. As a means of slowing the consumer boom it is far superior to a further general raising of interest rates because it is focussed on the appropriate target.** The policy on National Savings would either slow expenditure directly or, if funds are switched from building societies, should cause mortgage rates to rise by more than base rates, dampening expenditure indirectly. The sums attracted into National Savings and the impact on consumer's expenditure would not be enormously large, but could be as big as the tax cuts in the last Budget, which are usually blamed for the overheating. **Our suggestion should appeal to a Government that believes in market forces - the personal sector will be choosing to save with National Savings.**



ATTACHMENT 2

**Kleinwort Grieveson Charlesworth Limited** Member of the International Stock Exchange and of TSA
PO Box 560, 20 Fenchurch Street, London EC3P 3DB Telephone 01-623 8000

# Kleinwort Benson Securities

# GILT-EDGED MONITOR

## 1st September 1988

**Market View**

**Interest rate rises are continuing to prove a blunt instrument,** as far as the domestic economy is concerned. Further measures may well be required. Credit controls would be well received by the gilt market, but will be resisted by the Chancellor. Boosting national savings is feasible, but would lead to overfunding.. Therefore, perhaps the authorities should resume overfunding in gilts; this move would squeeze broader monetary aggregates, and also help to boost savings.

**The gilt market needs to watch carefully for any signs of a change in policy, in line with a return to overfunding. The implication would be a sharp flattening of the current downward slope of the yield curve.**

**FRNs**

**There is strong case to be made for switching medium-maturity gilts into UK mortgage-backed FRNs.** These FRNs are high quality paper, and offer both a substantial yield pickup and tax advantages, compared to gilts.

**Futures and Options**

The September 1988 long gilt futures contract is coming to an end; this heralds the departure of 12½% 2003/05 from the deliverable basket. This stock could now underperform 13½% 2004/08, which is the cheapest deliverable against the December future.

Negotiated options on gilts are attracting growing interest. These flexible tools, for example, allow an investor to take advantage of the high short rates and low volatilities in gilts at the moment, by selling long gilts, investing proceeds in the money markets, and buying cheap call options.

**Dr. Richard Golding**
**Stephen Scott**
**Dr. Joseph Mariathasan**
**John Dalton**

**DIRECTORS** C.W.L.Crook *(Chairman)* P.M.Clarke *(Chief Executive)* R.C.H.Jeens *(Finance Director)* S.C.N.Baguley S.T.Box W.G.A.Clegg J.M.Duchin J.Duckett R.J.A.Golding R.Helyar B.W.Lambert B.W.J.Manning P.G.D.Matthews A.D.Parrish
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# MARKET VIEW

Base rate rises - *pace* Mr Lawson - are not enough. Experience with the UK has always suggested that the domestic economy is much less sensitive to rises in interest rates than the other G-7 economies. Although the economy has turned out to have been over-stimulated, at least the authorities have been reasonably prompt in starting remedial action. However, further measures will be required.

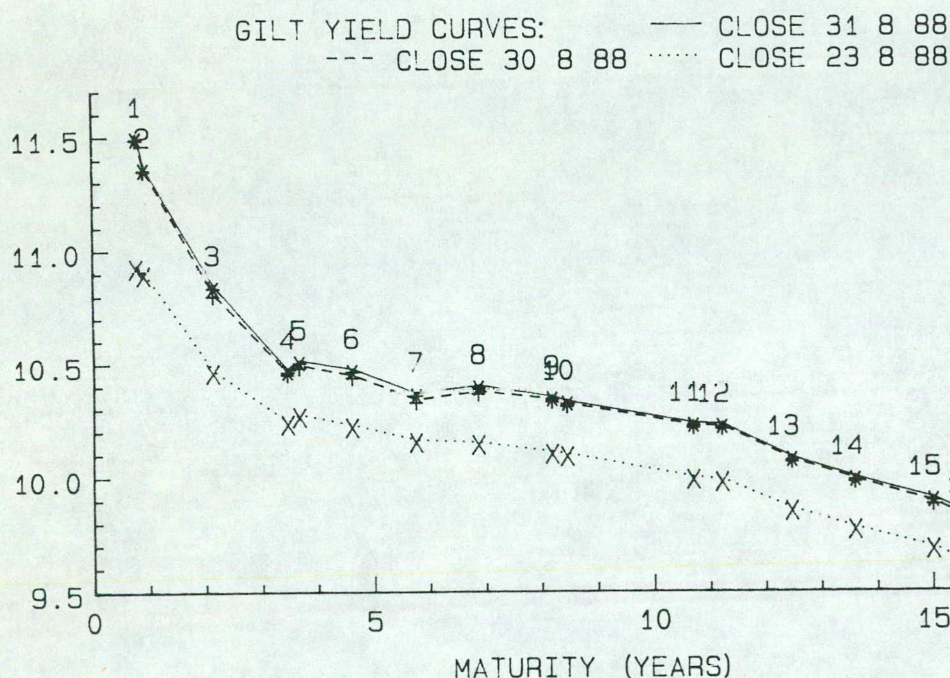
*Credit Controls?*

The measure that the Chancellor's critics have all been calling for is a reimposition of old-fashioned credit controls. Such measures would certainly be the favourite of the gilt market, as they would apparently lead to a completely painless reduction of credit without any rise in interest rates. Mr Lawson is surely right to resist such an ineffective measure. The main problem is not old-fashioned hire purchase credit, but lending on mortgage. It also seems likely that booking loans overseas could easily avoid any quantitative restrictions.

Measures to squeeze the capital base of the banking system, such as a call for Special Deposits, would be somewhat more effective. Devising equivalent measures for Building Societies to ensure a level playing field would be more problematical and there would still be the problem of loans being booked overseas, as used to happen under the old "corset" regime.

*Boosting Savings*

From a political point of view, direct or indirect controls on credit would be controversial and could involve a certain amount of eating of words. From an economic viewpoint, the measures would have to be fairly watertight and it is not clear that anyone possesses enough knowledge of the microeconomic consequences of such measures to be certain of their effect.




STOCKS

T 10H89 1
E 10 89 2
TC10 90 3
T 10 92 4
TC10H92 5
T 10 93 6
T 10 94 7
E 10Q95 8
C 10 96 9
E 10H97 10
T 10H99 11
C 10Q99 12
T 10 01 13
C 10 02 14
T 10 03 15
T 10 04 16
E 10H05 17

In contrast, measures to boost savings could be an acceptable additional measure. The fall in the level of the savings ratio is clearly a major factor behind the current consumer boom.

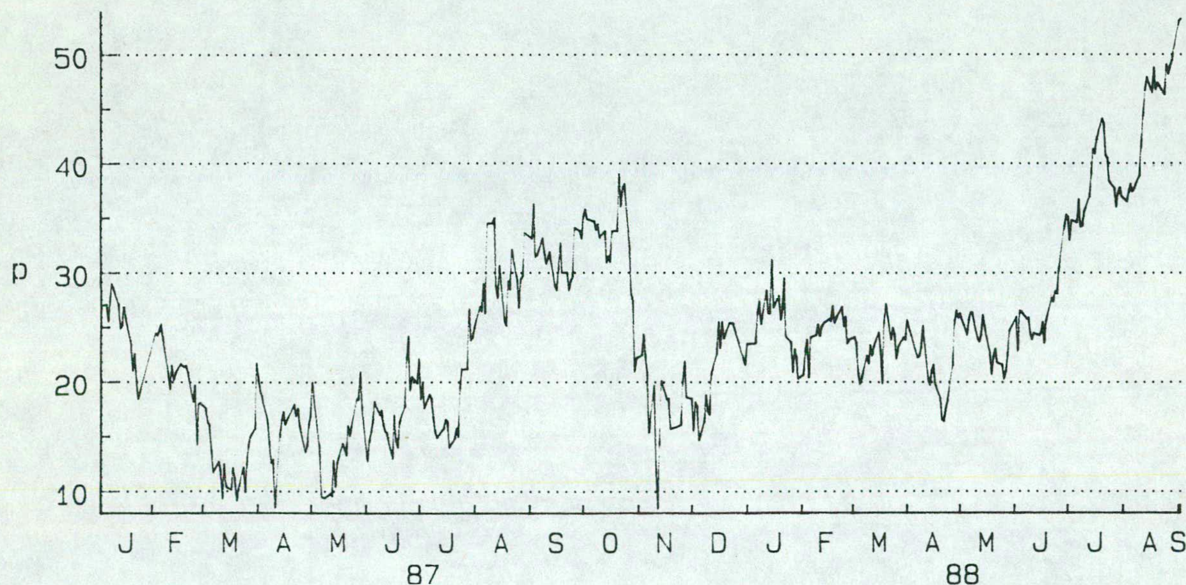
One possible route would be to boost National Savings, as a means of boosting personal savings generally. Although there were some rate rises on National Savings products announced late last week, these still leave them relatively uncompetitive. A new issue of savings certificates with a competitive yield and a £5000+ maximum could raise a lot of money in a short time from private individuals. This would squeeze the balance sheets of the banks and building societies and help to combat the rise in mortgage lending.

*Bring back Overfunding*

Of course a resumption of sales of National Savings products would lead to overfunding. This raises the possibility that the authorities could resume overfunding in gilts. This would not only squeeze the broader monetary aggregates, but might also help to boost savings. It does seem odd to repay debt to the private sector providing it with extra liquidity at this juncture.

The advantages of overfunding are principally that it would be quick and easy to do, and could be very effective in conjunction with a slightly higher level of short-term interest rates. Although, with the government buying back long gilts, the current tenor of policy seems quite different - there is always a danger of an unannounced policy change.

The gilt market will need to watch carefully for any signs of such a change. The implication would be a sharp flattening of the current downward slope of the yield curve.



est.ld/westhead/m2415.9.88

cc. Sir P. Middleton.

~~2/3 DM~~ recamp ~~losses~~

MP

CONFIDENTIAL

FROM: G R WESTHEAD
DATE: 15 SEPTEMBER 1988

PS/CHANCELLOR

cc:
Mr Peretz
Mr Grice

NATIONAL SAVINGS

The Economic Secretary has seen Mr Peretz's note of 14 September below on which he had the following comments.

2. The Economic Secretary thinks that Mr Grice's note is slightly overstated. The Economic Secretary observes that;

(i) The Greenwell/Kleinwort thesis is that DNS takes cash from persons possibly limiting their spending.

(ii) if Building Societies made good those funds from the wholesale markets that would come from institutions;

(iii) The Building Societies may not automatically borrow as much from the wholesale markets as they would have received from persons if large DNS borrowing was absent. In other words, Building Society lending may in a short-term be driven by the level of deposits;

(iv) DNS instruments (ie National Savings Certificates) are less liquid than Building Society deposits.

3. The Economic Secretary thinks that in general their argument is that when you pour honey it takes time to spread out and at first the honey is thicker where it is poured.

**GUY WESTHEAD**
**ASSISTANT PRIVATE SECRETARY**

mom/pa.009 CONFIDENTIAL

FROM: MISS M O'MARA
DATE: 20 September 1988

ECONOMIC SECRETARY

cc: Chancellor
Sir P Middleton
Sir G Littler
Mr Monck
Mr Scholar
Mr Moore
Mr Peretz
Mrs M E Brown
Mr Grice
Mr Bent
Mr Rich
Mr Tarkowski
Mr Cropper
Mr Patterson - DNS
Miss Wheldon - T Sol

**NATIONAL SAVINGS ORDINARY ACCOUNT**

Following your meeting with us last Wednesday, I attach a draft letter which you might send to the Chancellor of the Duchy, outlining the possibility of offering the Ordinary Account for sale to Girobank, once Girobank itself has been privatised.

2. We have discussed disclosure briefly with the Treasury Solicitor. On the basis that work on the options is, as the draft letter makes clear, at an early stage and that Treasury Ministers are nowhere near taking decisions, there should be no problem. A decision to offer the Ordinary Account to Girobank does not seem to cause difficulties in any case. If work were to go forward on the option of closing down the Ordinary Account or, still more, selling it to a third party, DTI and we would, however, have to look at the disclosure problem more carefully and check the representations which are being made in the context of the Girobank sale.

MOM

MISS M O'MARA

**DRAFT LETTER FROM ECONOMIC SECRETARY TO CHANCELLOR OF THE DUCHY OF LANCASTER**

**GIROBANK: NATIONAL SAVINGS BANK ORDINARY ACCOUNT**

I have been giving some thought to the future of the National Savings Bank Ordinary Account which is administered by the Department for National Savings at the National Savings Bank in Glasgow.

£1.7 billion is currently held on the Ordinary Account but the funds are potentially very liquid (deposits can be withdrawn on demand) and the Ordinary Account therefore makes no contribution towards financing the Government's funding requirements.

We have nevertheless until recently seen a role for the Ordinary Account in fulfilling a social need, by providing a simple deposit and withdrawal facility over Post Office counters for unsophisticated customers. However, Girobank also supplies these services and I have therefore started to question whether the Government should continue to provide this facility at all. The total of Ordinary Account deposits is in fact declining, but only slowly.

I foresee considerable difficulties in closing down the Ordinary Account outright and certainly should not want to propose that at this stage. However, I can see attractions in transferring the business to the private sector. Girobank seems the obvious candidate.

**CONFIDENTIAL**

I should stress that our thinking on all this is at a very early stage. We have as yet formulated no firm proposals, let alone taken any decisions. However, if further investigation indicates that purchase by Girobank could be a viable option, I should like, once Girobank's own sale has been completed, to put the possibility to its management, as they begin to map out their future strategy. Nevertheless, before commissioning any further work, I thought it sensible to enquire whether you saw any major difficulties in what I have in mind. I should not, of course, want any of our thinking revealed to Girobank at this point.

As you will appreciate, the future of the Ordinary Account is a highly sensitive issue for DNS management and I should therefore be grateful if you could ensure that this letter is given a restricted circulation within your Department.

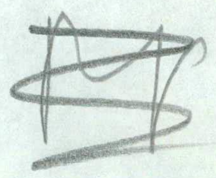
est.ld/MinmtgSJ/mtg14.9.88

CONFIDENTIAL

FROM: S M A JAMES
DATE: 26 SEPTEMBER 1988

NOTE OF A MEETING HELD IN ROOM 52/2, TREASURY CHAMBERS, ON WEDNESDAY 14 SEPTEMBER 1988

<u>Those Present:</u>



Economic Secretary
Mr Scholar
Mr Peretz
Miss O'Mara
Mr Bent
Mr Rich
Miss Anderson

Mr Patterson - DNS
Mr Wilson - DNS
Mr Bedeman - DNS

**MEETING TO DISCUSS NATIONAL SAVINGS CORPORATE PLAN, POSSIBLE ORDINARY ACCOUNT PRIVATISATION ETC.**

The meeting had before it Mr Rich's minute of 12 September and Mr Patterson's of 13 September.

2. The meeting discussed the possibility of selling the Ordinary Account to Girobank once the latter was in the private sector. DNS and Treasury officials agreed that if Ministers decided the idea was worth pursing a preliminary approach could be made to Girobank's new management in confidence after privatisation. The Economic Secretary was anxious thay any approach made should take place at an early stage; otherwise the new management might take strategic decisions on the bank's future which might rule out a subsequent purchase of the Ordinary Account. It was agreed there was no need for a feasibility study which might leak, and so risk provoking an adverse reaction from both staff and customers.

3. The Economic Secretary said that the Government would not wish to contemplate any option under which the owner of a

privatised Ordinary Account competed with Girobank through the same outlet of Post Office Counters. Mr Patterson noted that the Ordinary Account had so far been kept quite distinct from Girobank accounts, drawing particular attention to the £70 a year tax exemption. Mr Scholar mentioned the disclosure problems which might arise in the context of Girobank privatisation if it subsequently appeared the Government had been prepared to consider the sale of the Ordinary Account to a purchaser other than Girobank, without revealing this in the prospectus. However, if they decided to proceed Ministers would want to consider the propriety of offering the Ordinary Account to a single purchaser although this need not be ruled out, provided a persuasive defence could be mounted, and would wish to consider in these circumstances how best to ensure the Government obtained the maximum value for the assets sold.

4. Mr Bent noted that if Girobank were approached about a possible purchase of the Ordinary Account but displayed no interest, this would not rule out the option of privatisation in the longer term. The Government could still explore the possibility of separating Ordinary Account operations from other DNS business to make any future sale easier.

5. Mr Patterson noted that if Ministers' were seriously to contemplate a sale to Girobank, discussions would have to be widened to Post Office Counters. At this stage, they could no longer be kept confidential and he was concerned about the possible repercussions. The Economic Secretary was inclined to think that Ordinary Account savers were unlikely to react quickly or adversely to the news. But this was a question which could be reconsidered if the basic proposition was put to Girobank and they showed any interest. Other issues, such as the handling of DNS staff contracts, of separating the Ordinary Account from other DNS operations and of moving remaining accounts from Glasgow to Girobank offices would need to be addressed, if that stage were reached.

6. The Economic Secretary invited discussion of the other options for the future of the Ordinary Account and more widely of

**CONFIDENTIAL**

DNS. Discussion focused on whether DNS could move to agency status over the next 3 years at the same time as pursuing other major changes in the nature of its business. Mr Patterson felt it would be difficult to resolve the future of the Ordinary Account at the same time as a move to agency status. He was particularly concerned not to jeopardise the successful launch of the capital bond. The Economic Secretary thought the two developments could be taken forward together; agency status should allow DNS management a greater flexibility to take decisions on their future not limit the scope for action.

7. Treasury and DNS officials agreed that at first sight it would not require substantial changes for DNS to become an agency.

8. The Economic Secretary queried the long time scale foreseen by DNS for any sale of Ordinary Account or move to agency status. Mr Patterson explained that the Treasury Solicitor had advised any sale of the Ordinary Account would need first primary legislation. It was not suitable material for Finance Bill and there might be difficulty in finding a legislative slot. Moreover, if Glasgow had to close it would take time to wind down operations there.

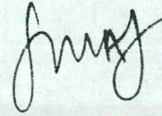
9. The Economic Secretary asked officials to take the following action:

i. Mr Peretz would provide a draft letter to DTI Ministers alerting them to the possibility of an approach to Girobank once privatised, although no decisions had yet been taken on the Ordinary Account's future;

ii. Further thought should be given to the propriety of a sale to Girobank rather than an open tender;

iii. Work should be done by Treasury and DNS on the possibility of a sale to the privatised Girobank of the Ordinary Account:

iv. The timetable for pursuing the options discussed, particularly for any legislation, needed to be explored.



S M A JAMES
PRIVATE SECRETARY

Those present

cc: PS/Chancellor
Mrs M E Brown
Mr Cropper

chex.md/aa/22 **CONFIDENTIAL**

**FROM: A C S ALLAN**
**DATE: 29 September 1988**

**MR PERETZ**

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Grice
Miss O'Mara
Mr Gieve
Mr Cropper

**OVER-FUNDING**

At the meeting on National Savings next week, the Chancellor would also like to discuss the case for over-funding. In present circumstances, this would imply ceasing to buy in gilts, rather than as in the past selling more gilts than we needed to fund a PSBR. He would be interested in an analysis of what we think the effects have been of the ending of over-funding.

2. He would welcome any initial comments you have before the meeting. But discussion can be continued at the subsequent meeting he will be holding to discuss reverse gilt auctions.

ACSA

**A C S ALLAN**

fim2.cr/Ritchie/M.13

15/10

FROM: ALLEN RITCHIE
DATE: 3 October 1988

MR PERETZ 3/10

cc Mr Scholar
Mrs Lomax
Mr Grice
Mr Ilett
Miss Noble
Mr O'Donnell
Miss O'Mara
Mr Dickson
Mrs Diggle (BSC)

**SETTING MORTGAGE RATES**

I promised you a short note on my findings so far from my investigation into how building societies set mortgage rates. I would stress that the views set out in this note are very preliminary. For the most part, they reflect a useful meeting with Paula Diggle and her colleagues at the BSC, and some rather basic analytical work of mine looking at interest rate differentials and building society margins on lending. I have also seen Adrian Coles at the BSA, on whom I tried out the story related here. He did not dissent from it as a general characterisation of how things work at present. But I have not as yet talked to any building societies, and the analytical work I have so far managed has been very rudimentary.

**Setting Building Society Interest Rates**

2. A broad characterisation of the present-day process of interest-rate-setting for the large building societies (the small ones mostly follow the leaders) would be to say that they first set the mortgage rate with reference to the rates being charged by their main competitors in the market for home loans - in particular, the new specialist mortgage lenders - and then set their (gross) deposit rates at a margin below the mortgage rate which will generate sufficient 'profits' on lending to enable the societies to comply with their capital ratio requirements. I should stress that this is no more than a broad characterisation of what in practice will be the outcome of a complex set of decisions about asset and liability management.

3. This is rather different from the situation which prevailed up to the beginning of the 1980s. The conventional wisdom then saw the process of interest rate setting as essentially the reverse of that described about. Building societies first set their deposit rates, with reference to rates offered by their competitors in the savings market - eg National Savings, banks' deposit accounts - and then set their mortgage rates at an adequate margin above gross deposit rates.

4. The change in interest rate setting behaviour reflects the radical changes which have taken place over the past seven or eight years in the nature of the business environment in which building societies operate. In the mortgage loan market, building societies now face strong competition from other lenders, whereas up to around 1981 they had the market to themselves. As a result, maintaining market share has become an important objective for building societies, particularly following a precipitous fall in their share of new lending during the course of 1987, which has since been partially reversed. Hence the current focus on setting mortgage rates competitively.

5. On the liabilities side of the balance sheet, building societies now raise a significant proportion (around 11 per cent) of their funds for lending on the wholesale money markets. On retail funding, the trend has been towards a much greater variety of retail accounts on offer, together with more sophisticated marketing. The result is that societies now have a range of alternatives for raising funds for lending at the margin - including various types of wholesale funding and more intensive marketing of their most attractive retail deposit accounts - without having to raise their retail deposit rates across the board. This greater flexibility in raising funds allows the societies to focus on matching funds to meet mortgage demand - rather than, as before, on rationing mortgage supply to match the (retail) funds available.

6. A further factor affecting interest rate setting behaviour is the capital adequacy requirements of the BSC, following the 1986

Building Societies Act. Although the societies have been given some scope to raise capital through subordinated debt, for the most part additional capital has to be generated through 'profits' on their mortgage lending activity. This in effect requires them to maintain adequate margins between their lending rates and their cost of funds.

**Interest Rate Differentials**

7. Building societies margins on retail - funded lending - as measured by the differential between the mortgage rate and the average rate paid on deposits, grossed up by the composite tax rate - have been remarkably stable over time, particularly over the last three years, as the attached chart shows. Since mid-1985, the margin on lending has kept within a narrow range of 1.9 to 2.3 percentage points, although there was more variation - and a generally lower level - in the first half of the 1980s. Thus a margin of 2 to 2¼ percentage points between the mortgage rate and the gross-up deposit rate looks to be a reliable rule-of-thumb.

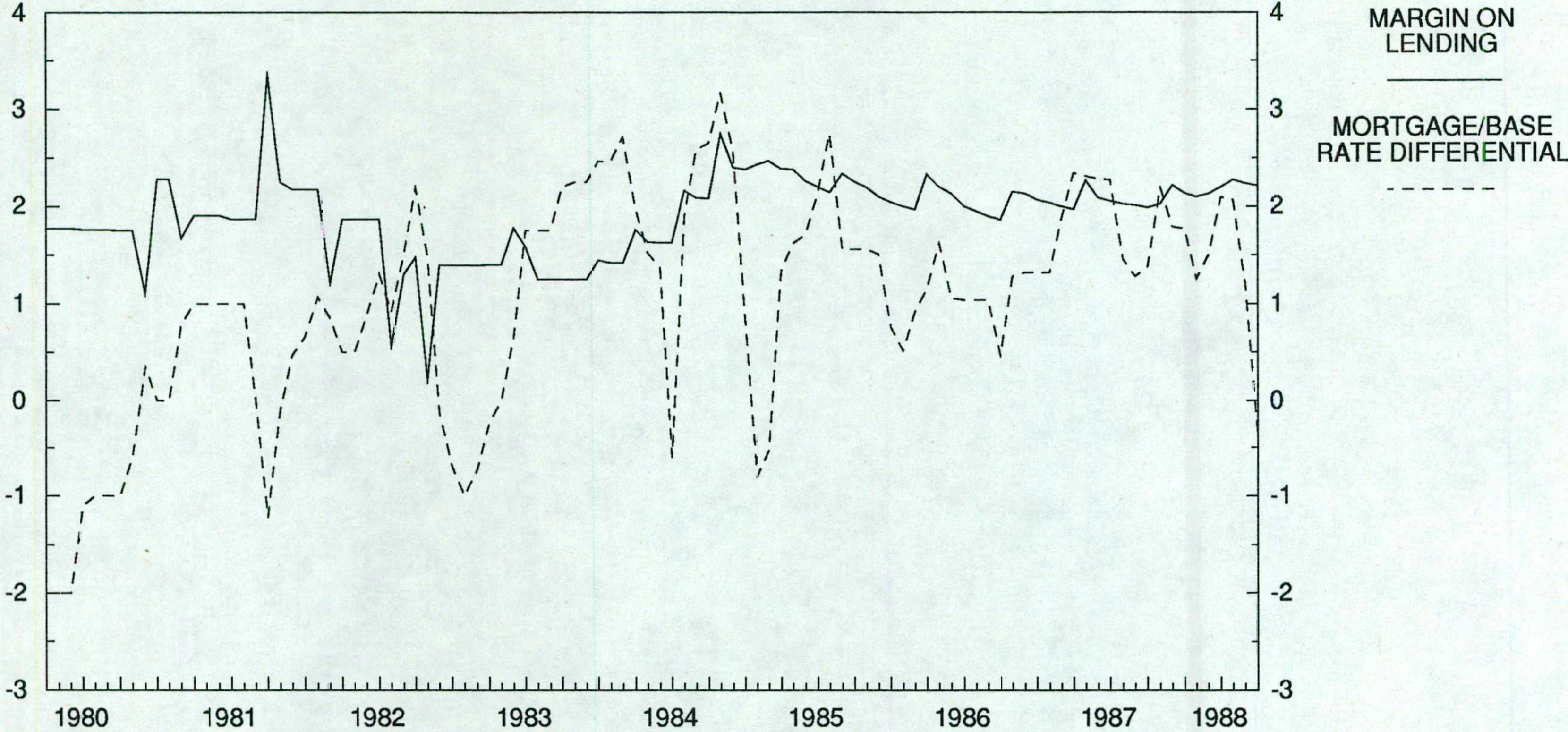
8. The relationship between the mortgage rate and base rates, also shown on the attached chart, is more indirect, and, not surprisingly, not as close as that between the mortgage rate and the deposit rate. With still only 11 per cent of funds coming from the wholesale markets, building societies' margins are not directly affected that much by a base rate change. But their competitors in the mortgage lending market are directly affected - especially the new specialist mortgage lenders, who tend to be almost entirely wholesale - funded. On the retail deposits side, the banks are probably a more important competitor than used to be the case - and banks' rates generally move quite quickly following abase rate change. These factors all point to a closer link between base rates and the mortgage rate than in the past.

9. The chart tends to bear this out, with smaller fluctuations in the mortgage rate/base rate differential over the past three years or so. But, even over this period, the differential has ranged from ½ per cent to 2½ per cent. Moreover, this is not just a case of lags in mortgage rate adjustment producing swings in the

differential in months when base rate is changed. The average differential was 1 percentage point for 1986, but nearly 2 percentage points for 1987, and has been around 1½ percentage points so far in 1988. A simple quantitative rule-of-thumb is much more difficult to come up with here.

**ALLEN RITCHIE**
**FIM2**

# BUILDING SOCEITIES' INTEREST RATE DIFFERENTIALS




April 1980 - July 1988

pso.jt/Middleton/min1.3

CONFIDENTIAL

From: SIR PETER MIDDLETON

Date: 3 October 1988

CHANCELLOR

cc Economic Secretary
Sir T Burns
Mr Scholar
Mr Peretz
Mr Grice
Miss O'Mara
Mr Cropper

**NATIONAL SAVINGS**

1. Perhaps I could make a comment before your meeting. The analysis in the Grice/Peretz minutes is compelling. We have to accept two propositions:

(a) the wholesale markets are now the marginal source of funds to the building societies;

(b) we do not want to increase the attractions of the more liquid National Savings instruments in an economy which is already over liquid.

But that does not dispose of the issue. There are some instruments which are good funding - particularly the Savings Certificate and the new Capital Bond. In my view we should maintain a very competitive rate on these instruments and ensure that this is well known to the public.

2. Firstly, I believe this would contribute to a much needed psychological effect. I should like to see the Government positively encouraging personal saving at a time when savings behaviour has changed sharply towards consumption. National Savings are an obvious instrument to use. Though we might give some thought to some more upbeat approach to savings in public presentation.

3. Second, I do not see what we have to lose. We want to keep interest rates high in this part of the yield curve. It will have

some psychological effect on the building societies which is worth having, and will undoubtedly take some personal savings from them.

4. Third, I think we may be underestimating the impact of the first point in the Economic Secretary's list. People across a wide spectrum of incomes have had their bank balances boosted by the tax cuts, especially in the higher income groups. We do not want to add to these from the stock of National Savings by having inadequate extension rates. And it seems to me both psychologically and economically appropriate to offer an attractive home for these cash balances when we have the means to do so.

5. I can see the attractions of waiting for the launch of the Capital Bond. But I do wonder whether something more timely on the certificate is called for. The obvious move would be an increase in the maximum holding, where we seem to have got more sensitive about the tax advantages as the higher rates have come down. I should be inclined to use a well directed instrument while we still have it.

P E MIDDLETON

mg.ee/dlcp/4.10-nsav

CONFIDENTIAL

From : D L C Peretz
Date : 4 October 1988

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler o/r
Mr Scholar
Mrs Lomax
Mr Odling-Smee
Mr Grice
Miss O'Mara
Mr Rich
Mr Ritchie
Mr Cropper

**NATIONAL SAVINGS, FUNDING AND OVERFUNDING**

It may be useful to table a few further reflections in advance of tomorrow's discussion. Mr Allan's minute of 29 September asks, in particular, for initial thoughts on the case for a return to overfunding.

**What influences building society rates?**

2. We have been doing some further work on this, and Mr Ritchie is part way through an exercise to try to improve our general understanding of the way that societies make their interest rate decisions nowadays. I attach a useful note recording the results of his researches so far. It looks as though, for the time being at least, the major determinant of building society mortgage rates is the rate being set on mortgages by new mortgage lenders - which are in turn closely related to wholesale money market rates. Building society deposit rates then follow the decision on mortgage rates, rather than lead it.

3. Experience in the last few weeks appears to confirm this. Certainly the very aggressive retail deposit rates set by some of the clearers from the beginning of September - which by Barclays' account was extremely successful in attracting a large volume of funds - had no perceptible effect on the Halifax/Abbey mortgage rate decision late in September. It is therefore hard to believe

that a more aggressive national savings stance would have had much effect either. One is driven to the conclusion that the one circumstance that might have led to a different building society decision would have been if the wholesale money market had been unsettled during the crucial week in late September, with a further base rate rise seeming imminent.

**National savings certificates**

4. My note of 14 September mentioned the possibility of announcing a new certificate, and Sir Peter Middleton has suggested increasing the holding limits for the present certificate (perhaps from the present £1,000 limit for new money to £5,000). There are two points here.

5. First, there is the relationship with the launch of the capital bond. The raison d'etre for this product is that we are unhappy about the cost, in tax forgone, of setting interest rates and holding limits on tax-free certificates at the levels required to produce substantial inflows from 25% taxpayers and non-taxpayers. We will need to explain this in public in announcing and subsequently launching the capital bond. So we would have a presentational difficulty - not necessarily insuperable - were we to raise the holding limits on certificates at the same time. (There is however a minor change that we and DNS have wanted to make for some time that would suffer less from this drawback : I would like to increase the limit on funds reinvested in savings certificates from money held on the very liquid general extension terms - from the present £5,000 reinvestment limit to £10,000).

6. Second, there is the relationship with the funding arithmetic. The note circulated on 14 September gave a forecast for net national savings inflows over the financial year of £1½ billion. We would now put this at least at £1$^{3}/_{4}$ billion, plus any extra money brought in by the capital bond in the first quarter of next year. The new savings certificate announced in July together with the rise in other national savings interest rates announced on 26 August are having some effect in net inflows, as is the prospective higher short-term inflation rate on

net flows into index-linked certificates. Given the PSDR, any additional inflows into national savings will have to be invested by acquiring financial assets or redeeming other Government liabilities - which leads to a comment on the overfunding debate.

**Overfunding**

7. My minute of 1 July (copy attached for convenience) set out the pros and cons of a return to overfunding in present circumstances, and argued against. We can put in hand some further analysis of what the effects of the end of overfunding have been, if that would be helpful. Ideally I should like to do this in consultation with the Bank of England. It is, perhaps, a piece of basic work we should be doing in any case, now that we have three years' experience of the "full fund" regime.

8. The arguments about overfunding are the same with a PSDR as with a PSBR - it is just that the signs are different. In both cases the aim of funding policy is to ensure that Government financing operations do not in themselves add to liquidity in the economy. The present funding rule is designed, broadly, to achieve this objective. It does so only approximately because some "funding" instruments are more liquid than others - a point we have in the past considered taking more explicitly into the rule itself by redefining it in terms of maturity of borrowing instrument rather than sector of purchaser.

9. With a PSDR the question is not how to borrow, but which financial assets to buy or which liabilities to redeem? Looked at this way, the dividing line between full funding and overfunding may not seem particularly clear cut. For example, we have a choice whether :

a) to buy foreign assets, or redeem liquid sterling liabilities such as CTDs and some national savings products, or to buy in gilts - including very liquid gilts with short maturity dates. All of these operations would involve keeping to the full fund rule. Or,

b) to buy commercial bills/or increase money market assistance in other ways. This would constitute overfunding, on the definition.

10. Whatever the other advantages or disadvantages of overfunding, the way that in the past it led to an increase in the Bank of England's holdings of commercial bills - the size of the bill mountain - was a real difficulty. Because the bill market is so small and artificial (it might hardly be there at all if the Bank of England did not operate in it) the Bank's holdings of commercial bills as a share of the total market can quickly rise to a point where it leads to distortions and round tripping.

11. We have considered other options in the past. For example placing deposits direct with the banking system as an alternative form of money market assistance. We have hitherto been concerned about the credit risk of putting money with individual banks without security. Another option, which in fact would not constitute overfunding, would be to refinance ECGD guaranteed bank loans. However statistically this would add to public expenditure and reduce the PSDR, and is unattractive on those grounds.

12. Leaving other arguments aside, given the difficulties likely to arise from a sharp increase in the size of the bill mountain I would myself think it preferable to seek to achieve a similar impact on liquidity, if desired, by buying-in short maturity gilts (there is a bulge in maturities next year) - which as it happens can be done within the present full fund rule.

13. It is also worth remembering that there is one further degree of freedom available to us without changing the funding rule. We have always allowed for some "carry over" of funding from one year to the next, and in last year's Mansion House Speech you explicitly said that net intervention would not necessarily be funded entirely within the financial year in which it took place. You went on to say that in the post-crash circumstances of the day it would not be sensible "to extract liquidity on a major scale". You could consider saying something similar, but with a reverse

sign, in this year's Mansion House Speech : ie that in current circumstances it would be helpful to allow liquidity to be temporarily withdrawn from the system. This would imply a temporary, but not permanent, increase in the size of the bill mountain.

**Encouraging saving**

14. Finally, we should not lose sight of the other objective that aggressive selling of suitable national savings products might achieve : increasing genuine personal sector saving. For this we need products that encourage real long-term saving, and that insofar as possible have no obvious private sector counterparts to give some hope that they will attract new saving as well as divert money from elsewhere.

15. The new capital bond meets these criteria well, and that is an additional reason for being prepared to sell it, and use the proceeds to buy-in other forms of Government liability that are probably doing less to increase the totality of saving in the economy.

**Summary**

16. This note is longer than I intended. To summarise very briefly :

i) further work seems to confirm that the main determinant of building society mortgage rates is the rate of interest in wholesale markets, not competing retail deposit rates or national savings rates.

ii) there may be a presentational difficulty, which would need careful handling, in raising the national savings certificate holding limit at the same time as introducing the capital bond, though I would very much like to raise the limit on amounts that can be reinvested in the current certificate from funds on general extension terms.

iii) there is no magic about the full fund rule, though it has kept us from getting into the kind of presentational and operational tangle we got into in 1985 with a large and rising bill mountain. There is a good deal we can do within the current rule to use the public sector surplus to reduce liquidity in the economy, at least temporarily.

iv) one of the arguments we should not forget for the new capital bond is that it is the kind of product that might help raise the overall level of genuine saving in the in the economy, even allowing for the fact that the proceeds would be used to reduce other forms of Government borrowing.

DLCP

**D L C PERETZ**

pup

**NOTE OF A MEETING IN NO.11 DOWNING STREET AT 3.00PM ON WEDNESDAY 5 OCTOBER**

**Present:** Chancellor
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz
Mr Gieve
Mr Grice
Miss O'Mara

---

**NATIONAL SAVINGS, OVERFUNDING etc**

**Capital Bond**

The Chancellor said that he accepted that there was little scope for using national savings to syphon money from the building societies and influence mortgage rates. The main issue was whether we could encourage an increase in personal savings generally, perhaps via the psychological impact of new National Savings products. The capital bond seemed an ideal instrument from this point of view, and he would now be announcing it in his Party Conference speech. The details should be announced on the same day, in a press release by the Economic Secretary.

2. The Chancellor asked how soon it would be possible to introduce the capital bond. Miss O'Mara said that the earliest that would be practicable for DNS would be the first week in January. The Chancellor asked her to press DNS to make sure that was achieved.

Reinvestment Limit

3. The Chancellor thought the increase in the reinvestment limit to £10,000 which Mr Peretz had proposed seemed thoroughly sensible. This change was agreed.

Other National Savings instruments

4. The Chancellor said he could see that there was a case for raising the maximum holdings for the present savings certificate in the period before the capital bond came in; but he thought it would represent a difficult reversal of policy. The Economic Secretary agreed: one of the justifications for the capital bond was that we could have a much higher limit without giving a larger tax break to the rich; it would be very difficult to present this if at the same time as we increased the limit on existing certificates and hence did give a larger tax break to the rich.

5. There was also some discussion about the General Extension Rate. The point was made that funds held on GER terms were extremely liquid and not very good quality funding. But on the other hand it would not be very desirable to see a substantial net withdrawal from national savings: the best outcome would be if much of the money now held on GER terms was invested in the new capital bond. It was agreed that the level of the GER needed to be monitored carefully.

Over-funding

6. The Chancellor said he accepted that our funding rule should in principle be symmetric, and that we should aim for a "full un-fund",certainly until the study of the experience with the ending of over-funding had been completed. But that left the question of whether we should make a temporary departure from the funding rule. In last year's Mansion House speech he had said it

was not sensible in the market circumstances prevailing then to take liquidity out of the system; there was equally a case for saying that it was not sensible in present circumstances to put liquidity into the system. The line would be that in the short-term it might make sense either to fund or not to fund, but it did not make sense to do systematic over- or under-funding. The danger with this line was that it risked conceding that we did think that adding liquidity via a full under-fund was inflationary. A possible alternative would be to vary the maturity of the debt we bought in, with the aim of influencing liquidity that way; there was, for example, not much difference in practice between buying in next maturities under a full funding policy or buying in commercial bills under a (temporary) over-funding policy.

7. The Chancellor asked for views on the shape of the yield curve, and whether we should be buying in long or short gilts. In discussion the following points were made:

i. the advantage of buying in long gilts was that it kept long yields low and might help to tighten monetary conditions without harming industrial investment;

ii. one of the problems of over-funding had been that it had driven up long rates and encouraged companies to issue shorter-term debt; driving down long rates and encouraging longer maturity debt had corresponding advantages;

iii. on the other hand, buying in next maturities took liquidity out of the economy directly;

iv. an element of the PSDR was privatisation proceeds, and offsetting that by buying long gilts seemed appropriate;

v. long gilts were expensive funding on the assumption that the Government would achieve its zero inflation objective; but they did offer an insurance policy.

(vi) It would not be very attractive to stop buying in long gilts and start buying in next maturities if the effect was to push up long yields; but, on the other hand, there were good grounds for thinking that the effect would primarily be to smooth out the yield curve.

8. <u>Mr Scholar</u> noted that much work had been put into persuading the Bank to take the proposal for reverse gilt auctions seriously, rather than going for over-funding; and into persuading them to buy in long gilts. He thought, in these circumstances, it would be more sensible to wait for the Bank's advice on reverse gilt auctions before commissioning the study of the experience of the ending over-funding or floating with the Bank the idea of switching to buying in next maturities. The Bank were in fact likely, in their paper on reverse gilt auctions, to recommend that auctions were restricted to next maturities in the first instance. There were definite practical advantages in that.

9. The <u>Chancellor</u> said he would want to continue discussion of these issues at the meeting on reverse gilt auctions, when we had the Bank's paper. In the meantime, he would be grateful for further advice on the various possible ways of handling these topics in the Mansion House Speech. One possibility was to use the line discussed in paragraph 6 above. Another was to announce simply that we would be concentrating debt repayment at the shortest and most liquid end for the time being. A third possibility was to announce the plans for reverse gilt auctions in

the Mansion House Speech, rather than in the Autumn Statement, providing this could be done plausibly without giving a new PSDR forecast.

ACSA

**A C S ALLAN**

Distribution:

Those present
Sir G Littler o/r
Mrs Lomax
Mr Odling-Smee
Mr Hudson
Mr Rich
Mr Ritchie
Mr Cropper

mom/pa.081 **CONFIDENTIAL**

MP

**FROM: MISS M O'MARA**
**DATE: 7 October 1988**

**ECONOMIC SECRETARY**

cc: Chancellor
Financial Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Peretz
Mr Gieve
Mr Gilhooly
Mr Grice
Mr Rich OR
Mr Cropper
Mr Corlett - IR
Mr Patterson - DNS

Ch/ sorry not to have shown you this over the weekend, but it was attached in a string of other pps and I didn't spot it was new.

EST's reaction is that IR's case for not fiddling with tax principles is pretty overwhelming.

I agree

MPW 12/10

**CAPITAL BOND: TAX TREATMENT**

You will recall that in the background note attached to my minute of 30 September, I mentioned a possible complication which had emerged in relation to the tax treatment of the Capital Bond which we discussed briefly with you on Tuesday (with Ch?) Since the launch of the Bond has now been postponed until 13 October, it gives us an opportunity to explain the potential problem in more detail and to take your mind on the way in which it should be resolved.

The problem

2. As you know, interest on the Bond is to be capitalised on each anniversary of the date of purchase but will not be paid until the Bond itself matures after five years - or on repayment, if that occurs earlier. Interest will be paid gross but will be subject to income tax. DNS had proceeded on the basis that savers would have to include the amount of interest earned in their tax returns for the year in which the interest was credited and capitalised and had arranged to send holders an annual statement of value to enable them to do so. This would follow precedent for the taxation of the Investment Account and the Deposit Bond, both of which accumulate and credit interest annually. It reflects the general tax principle, rooted in case law, that interest arises for assessment purposes at the time it is credited and is the normal treatment for investments where income is accumulated in this way.

3. The result is that savers would be liable to pay tax on the Bond for several years before they received any money from DNS.

4. DNS do not see any marketing problem in this. They point out that the problem of annual tax liability arises with any gross scheme which credits interest, as distinct from those which pay interest annually, and they cannot recall any complaints from customers about the need to settle tax liability before interest is paid out in the case of either the Investment Account or Deposit Bonds. They note that the terms on which the Capital Bond will be issued would in any event permit customers to arrange an annual withdrawal to settle their tax liability, if they wished to do so, and of course, not all savers will be liable to tax.

5. However, we and the Bank believe that the proposed tax treatment would be a marketing minus. No one likes to pay tax but it is doubly painful to have to pay it before receiving the corresponding income. Most investors liable to tax will probably pay the additional sum through an adjustment to their PAYE coding, in the way that many higher rate taxpayers already pay additional tax on bank and building society interest. This may take the edge off the pain but it will not eliminate it and it will not apply to all savers. In particular, we think the tax treatment could deter some large investors whom we have sought to attract by the £100,000 maximum holding, especially as the interest rate penalty on early withdrawal (which does not apply to the Investment Account or Deposit Bonds) would discourage partial cashing-in to meet tax liabilities.

<u>Other options</u>

6. Since the principle of assessing interest in respect of the year in which it is credited is so firmly based, any different treatment for the Capital Bond would require legislation in the Finance Bill. The Revenue's advice is strongly against this course.

7. National Savings already enjoy special tax treatment because interest, where taxable, is paid gross and certain products are tax exempt. Although this is a separate issue, if Capital Bonds

were taxed in a differential way, that could risk reopening the debate about the tax status of National Savings products as a whole which followed the introduction of CRT. Also, and possibly harder to resist, there would probably be pressure to extend the tax treatment of the Capital Bond to similar private sector products and other investments where income is accumulated rather than distributed, for example, some unit trusts and, more generally, high interest savings accounts which require the investor to leave money on deposit for a minimum term, subject to an interest penalty for early withdrawal. We assume you would not want to alter the current tax treatment of Deposit Bonds (which will continue to exist, even though new Bonds will be withdrawn from sale from 19 November) but Ministers would be bound to be urged to do so.

8. DNS also believe they would find it very difficult to explain a tax treatment for the Capital Bond which differed from that of the Investment Account or those Deposit Bonds which continue to be held. Indeed, they would regard a different tax treatment as complicating rather than enhancing marketing.

9. If nevertheless the Government were to require tax to be paid on the Capital Bond only on repayment, the simplest way to achieve this would be to tax the investor at that point at his marginal rate on all the accumulated interest. However, in some cases, that could push him into higher rate tax for which he would not have been liable, had he been taxed year by year as the interest was actually earned. (Against that, the taxpaying investor would enjoy a cash flow advantage from not paying any tax until his Bond matured.) Similarly, some non-taxpayers could find themselves paying basic rate tax, if the liability was deferred until maturity.

10. This could be avoided by some form of "top-slicing", whereby tax would be apportioned at the marginal rate payable in each year in which the interest was actually earned, although the tax liability would not fall due until the Bond was actually repaid.

But such an arrangement could be difficult for some taxpayers to understand and would certainly be complex for the Revenue to administer. It is partly for these reasons that Ministers have sought to remove the principle of top-slicing from our tax system generally in recent years and the Revenue consider it would be wholly inconsistent to reintroduce it now. Again, it would create pressure for its introduction in other areas eg the taxation of compensation payments arising from court awards.

Conclusion

11. We attach importance to the success of the Capital Bond on grounds of monetary policy and cost and in the context of restructuring the Government's debt portfolio but both we and the Bank see marketing drawbacks in the normal tax treatment, although DNS do not. However, departure from the normal assessing rules would involve an element of tax deferment for investors and would lead to problems over top-slicing, since deferment without top-slicing would probably give little net marketing advantage. In the Revenue's view, these disadvantages are overriding. If, nevertheless, you consider special treatment may be needed, they will minute you separately in more detail, including possible legislative options.

12. It would be helpful to have an indication of your views by early next week, if possible, so that we can reflect them in the background briefing we prepare for the Bond's launch. However, as we told you, we do not need to announce how the Bond will be treated for tax purposes until we provide full details of its terms shortly before it is put on sale in January.

13. This submission has been produced in consultation with DNS, the Inland Revenue and FP.

MOM

**MISS M O'MARA**

Ch/

amended
to reflect
decision
not to have
limit

mpw.

mom/pa.088 CONFIDENTIAL

FROM: MISS M O'MARA
DATE: 7 October 1988

**CHANCELLOR OF THE EXCHEQUER**

cc: Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz
Mr Gieve
Mr Grice
Mr Rich OR
Mr Cropper

**CAPITAL BOND**

I attach, as requested, a draft minute to the Prime Minister, setting out the details of the new Capital Bond which you have told her you will be announcing in your Party Conference speech.

2. The draft draws heavily on the presentation in the Economic Secretary's press release, of which I have submitted a revised version this evening. I have not, however, referred to the withdrawal of the Deposit Bond or to the doubling of the reinvestment limit on savings certificates.

MOM

MISS M O'MARA

DRAFT MINUTE TO PRIME MINISTER

NATIONAL SAVINGS: CAPITAL BOND

As I mentioned to you briefly earlier this week, I am planning to announce in my Party Conference speech that we shall be putting a completely new National Savings product, the Capital Bond, on sale from January.

2. Although the public sector is now in substantial surplus, a significant proportion of gilts continues to mature each year and individual savers withdraw funds from National Savings to spend or invest elsewhere. So we still need to attract new money to replace part of this natural run down. Nevertheless, the fact that we are now the major net repayer of debt in the economy has given us an opportunity to consider how best we can reduce the cost of servicing debt and improve its quality. At the same time, we want to encourage genuine saving in the economy, as you yourself have made clear.

3. I believe the Capital Bond should meet all these objectives. Like the traditional savings certificate, it will offer a guaranteed return and we shall set its interest rate to increase each year of its five year life to encourage investors to hold it to maturity. The new feature is that interest will be paid gross but will be subject to tax.

4. Since savings certificates are free of tax, they provide disproportionate gains for higher rate taxpayers. We have therefore placed a £1,000 limit on the amount of money which can

be invested in them. As interest on the Capital Bond will be taxable, we have no need to limit the amount of revenue forgone and we have therefore increased the maximum holding to £100,000. I believe this will add significantly to the Bond's attractions. At the same time, since we shall be paying interest gross, we shall provide a further home for the savings of the non-taxpayer, by offering a return free of all tax deductions.

5. As a result, I am confident that the Capital Bond will tap a new market, encourage additional long-term saving and help improve the quality of the Government's borrowing. In making the announcement, I also intend to take the opportunity to stress the benefits of increased saving generally, both to the economy and to the individual.

mom/pa.073

CONFIDENTIAL

FROM: MISS M O'MARA
DATE: 7 October 1988

ECONOMIC SECRETARY

cc: Chancellor
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz
Mr Gieve
Mr Grice
Mr Bush
Mr Hudson
Mr Rich OR
Mr Cropper
Mr Patterson - DNS

C.
1. Policy question on timing, at para 6.
2. See draft of EST's background statement. It will need a v. clear cover sheet ~~making~~ linking it to your announcement.

**LAUNCH OF CAPITAL BOND: THURSDAY 13 OCTOBER**

The Chancellor will be launching the Capital Bond in his Party Conference speech next Thursday but has asked you to make a separate announcement, setting out the background and details. We have therefore amended the draft speech you have already seen, removing the specifically Glaswegian tone and inserting a reference to doubling the reinvestment limit on the 34th issue. We have taken on board your comments reported in Miss James' minute of 3 October but there are just three points on which we want to take your mind further.

2. First, you suggested that we might reword the last sentence of the second paragraph to:

> "Even with the budget surplus, we need to attract <u>a substantial amount of</u> new money to replace part of this natural run down."

It is certainly true that around £8 billion of gilts mature this year, and on top of that there are normal withdrawals from National Savings. However, as you know from our last funding meeting, gilts redemptions are more than offset eg by our latest PSDR forecast, although that is not, as yet, public knowledge. We are concerned that referring to "a substantial amount" of new money could give the wrong signal, especially since the Chancellor

PS. Why is there a £100,000 limit? ie. why is there a limit at all?

wishes to announce a reverse auction either in his Mansion House speech or in the Autumn Statement. We would prefer to revert to the original "some".

3. Second, you suggested the penultimate sentence of the third paragraph should now read:

> "The quality funds we want in National Savings are those which savers will leave with the Government untouched for a number of years, not those which are liable to be withdrawn at very short notice with no penalty to the saver."

In fact, GER funds (which we would prefer to see reinvested in other better quality National Savings products) can involve the loss of up to three months' interest if the saver mistimes his withdrawal. We therefore suggest amending to "with little or no penalty to the saver". DNS agree.

4. Finally, although you suggested that we might retain the second sentence of the original paragraph 6, it looks redundant in the speech as redrafted and we have therefore omitted it. We have reflected your proposed change of emphasis in paragraph 7 too.

5. Subject to your views on these points, we shall produce a final version of the text for IDT. You will also want to look at the DNS press release to see whether it contains any crisp phrases which could be reinserted.

6. The Chancellor has stressed the importance of putting the Bond on sale in the first week of January at the latest. We have discussed this with DNS. It would be possible for them to make the Bond available for purchase on 4 January (2 January is a UK Bank Holiday and 3 January a Bank Holiday in Scotland). However, because of complications over the handling of Christmas mail, the interest rate would have to be set several weeks in advance for the Post Office to guarantee that printed prospectuses would be available everywhere by the beginning of January. If the Bond were

put on sale from 9 January, the first Monday in the month on which all UK Post Offices are open, the interest rate could be set quite a bit later, since we should largely have avoided the holiday period. In the light of this, we should be grateful to know whether you still want us to proceed with a 4 January starting date.

7. I am sending you a separate submission on the tax treatment of the Bond which we discussed briefly with you on Tuesday.

MOM

**MISS M O'MARA**

**DRAFT SPEECH**

In these days when the Government is running a substantial budget surplus, some have doubted whether we still need the finance which National Savings raises year in, year out from the personal sector. We do: the Government sees an important and continuing role for National Savings.

Although we no longer have to raise money to finance a budget deficit, we still have around £200 billion of Government debt outstanding, of which £37 billion is held in National Savings. Each year a significant proportion of gilts matures, and individual savers withdraw funds from National Savings to spend or invest elsewhere. Even with a budget surplus, we need to attract [a substantial amount of] new money to replace part of this natural run down.

At the same time, the fact that this year and last the Government has been a substantial net repayer of debt for the first time since the end of the 1960s has given us the opportunity to examine critically how best to finance our borrowing. Governments in the past, with an urgent need to borrow on a large scale, were less well placed to consider reducing the cost of servicing their debt or improving its quality. The quality funds we want in National Savings are those which savers will leave with the Government untouched for a number of years, not those which are liable to be withdrawn at very short notice with [little or] no penalty to the saver. And we want to tap new sources of funds so that we encourage genuine saving in the economy.

The Chancellor has therefore announced today that from January we shall be offering a completely new National Savings product for sale which displays just these characteristics. It is called the Capital Bond. The new Bond will offer a guaranteed return, and its interest rate will be set to increase each year of its five year life to encourage investors to hold the Bond to maturity [in five years' time.]

The new feature of the Capital Bond is that it will combine this guaranteed return - which savings certificates also offer - with interest that is paid gross but subject to tax. The interest rate will be higher, to reflect this tax treatment. A Treasury Minister knows better than most that no one enjoys paying tax! But I believe that the new tax treatment we are proposing for the Capital Bond actually has considerable advantages.

Since the interest is paid gross, people who do not pay tax will continue to receive a return free of all tax deductions, in line with our continuing policy of providing a home for the savings of the non-taxpayer. That means no tax to pay for many pensioners and, once we move to independent taxation, for many ~~wives too.~~ married women whose only income is from savings, too. But at the same time, [the tax treatment of the Bond will not involve the Exchequer forgoing top rate tax from higher rate taxpayers. [Their returns will be subject to the top rate of tax.]] higher rate taxpayers will pay tax on their returns at their marginal rate.

The Bond also offers the individual a much bigger opportunity for investment than the traditional savings certificate. Because Capital Bonds will be subject to tax, there will be no need to seek to limit the amount of revenue forgone. So we can increase the maximum holding a hundred-fold, from the £1,000 limit on new money which applies to the current savings certificate to a £100,000 limit on all purchases of Capital Bond issues combined.

The Capital Bond will therefore, [I believe,] tap a new market, stimulate additional long-term saving and help improve the quality of Government borrowing.

With the same aim of encouraging good quality saving, we shall from Saturday double to £10,000 the limit on reinvestment from older savings certificates into the current 34th issue.

In order to release the staff resources we need to launch the new Bond, we have decided to withdraw the Deposit Bond from sale from 19 November. Purchases of Deposit Bonds have always been relatively modest: we have sold less than £95 million since the beginning of this year, only a tenth of the sales of their close counterpart, the highly popular Income Bond. Income Bonds will remain on offer and continue to provide those features - payment of interest gross and access to a guaranteed sum of capital at three months' notice - which investors have found attractive in the Deposit Bond, plus the advantage of receiving regular monthly payments of interest.

The Capital Bond opens up an exciting prospect - National Savings' first new product for three years. I believe the public will find it attractive too.

chex.ps/mw/53 CONFIDENTIAL

FROM: MISS M P WALLACE
DATE: 10 October 1988

PS/ECONOMIC SECRETARY

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz
Mr Gieve
Miss O'Mara
Mr Grice
Mr Bush
Mr Hudson
Mr Rich
Mr Cropper

Mr Patterson - DNS

LAUNCH OF CAPITAL BOND: THURSDAY 13 OCTOBER

The Chancellor has seen Miss O'Mara's minute of 7 October. He has commented that he would suggest a shorter version, which should start by referring to his announcement, and which could eliminate the present first page entirely. He would be grateful for the opportunity to look at a version revised on this basis.

2. As I mentioned to you, the Chancellor has also queried the proposed £100,000 limit for the Capital Bond, and has asked the Economic Secretary to consider whether this is justified.

MPW.

MOIRA WALLACE

est.ld/james/m18.10.10

12
BF 11/10

CONFIDENTIAL

FROM: S M A JAMES
DATE: 10 October 1988

MISS O'MARA

cc: PS/Chancellor
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz
Mr Gieve
Mr Grice
Mr Bush
Mr Hudson
Mr Rich
Mr Cropper

Mr Patterson - DNS

**LAUNCH OF CAPITAL BOND : THURSDAY 13 OCTOBER**

The Economic Secretary was grateful for your minute of 7 October.

2. The Economic Secretary is content with the draft speech attached to your minute. He agrees with your amendments to his suggestions on the original draft. He has however commented that in the light of paragraph 3 of your minute, he is not clear why Capital Bonds will provide much better quality saving than GER.

3. On the starting date for sale of the Capital Bond, the Economic Secretary is inclined to go for Monday 9 January but would like to have the time difference for setting the interest rate quantified.

SMAJ

S M A JAMES
PRIVATE SECRETARY

mom/pa.092 CONFIDENTIAL

FROM: MISS M O'MARA
DATE: 11 October 1988

ECONOMIC SECRETARY

cc: PS/Chancellor
Sir P Middleton OR
Sir T Burns
Mr Scholar OR
Mr Gieve OR
Mr Grice
Mr Bush
Mr Hudson
Mr Rich
Mr Cropper
Mr Patterson - DNS

**LAUNCH OF CAPITAL BOND: THURSDAY 13 OCTOBER**

I attach a revised and shortened version of your press release, amended in the light of your own and the Chancellor's comments.

2. As you know, DNS feel it would be inappropriate for them to reproduce the full text in their own press release. IDT see no difficulty in issuing it in the form of a separate Treasury press notice. Indeed, they believe this approach could provide further publicity both for the Bond itself and for the wider message that the Government wants to encourage saving in the economy.

3. We shall need to check the direct quotation in the Notes to Editors on Thursday morning. On IDT's advice, we have not stated where the Chancellor announced the launch of the Capital Bond because of the need to avoid even purely factual references to Party occasions in departmental press notices.

4. You asked why we believe Capital Bonds will provide much better quality saving than funds on the GER, if an interest rate penalty is attached to GER withdrawal too.

5. First, GER funds can be withdrawn virtually on demand (in practice, within about 8 days). Withdrawals from the Capital Bond will require 3 months' notice. So GER funds are potentially much more liquid.

6. Second, while savers can lose some interest if they mistime their withdrawal of GER funds (which is why we suggested a slight amendment to your own redraft of the text of the release), the penalty is much less than that on the Capital Bond. The repayment value of a savings certificate increases for each complete 3 months it has been held beyond the expiry of the previous fixed period term. So holders of funds on the GER could lose up to 3 months' interest if they timed their withdrawal incorrectly. By contrast, holders of the Capital Bond will not be entitled to any interest at all, if they seek repayment within the first year of the Bond's life. They will then earn a higher rate of interest for each full year they hold the Bond so that the best return is available only on Bonds held to maturity.

7. We therefore believe the Capital Bond offers us much higher quality funding, because it cannot be withdrawn on demand and also because it gives investors a positive incentive to lock in their funds for a full five years, which the GER does not.

8. DNS will be minuting you separately on the starting date for sale.

MOM

MISS M O'MARA

mom/pa.057

Commenting on the Chancellor's announcement earlier today that at the beginning of next year, the Government would be launching a completely new National Savings product to encourage savings further, the Economic Secretary to the Treasury said:

"The new Capital Bond will offer a guaranteed return, and its interest rate will be set to increase each year of its five year life to encourage investors to hold the Bond to maturity. The new feature of the Capital Bond is that it will combine this guaranteed return - which savings certificates also offer - with interest paid gross but subject to tax. The interest rate will be higher, to reflect this tax treatment.

Since the interest is paid gross, those who do not pay tax will continue to receive a return free of all tax deductions, in line with our continuing policy of providing a home for the savings of the non-taxpayer. That means no tax to pay for many pensioners and, once we move to independent taxation, for many wives too. But at the same time, the tax treatment of the Bond will not involve the Exchequer forgoing top rate tax from higher rate taxpayers.

The Bond also offers the individual a much bigger opportunity for investment than the traditional savings certificate. We have limited the maximum amount of new money a saver can put in the current savings certificate to £1,000 to restrict the amount of revenue forgone from investment by higher rate taxpayers. But we have no need to place any limit on individual holdings of the Capital Bond because it will be subject to tax.

The Capital Bond will, I believe, tap a new market, stimulate additional long-term saving and help improve the quality of Government borrowing.

With the same aim of encouraging good quality saving, we shall from Saturday double to £10,000 the limit on reinvestment from older savings certificates into the current 34th issue.

In order to release the staff resources we need to launch the new Bond, we have decided to withdraw the Deposit Bond from sale from 19 November. Purchases of Deposit Bonds have always been relatively modest: we have sold less than £95 million since the beginning of this year, only a tenth of the sales of their close counterpart, the highly popular Income Bond. Income Bonds will remain on offer and continue to provide those features - payment of interest gross and access to a guaranteed sum of capital at three months' notice - which investors have found attractive in the Deposit Bond, plus the advantage of receiving regular monthly payments of interest.

The Capital Bond opens up an exciting prospect - National Savings' first new product for three years. I believe the public will find it attractive too."

a bit over the top

**Notes to Editors**

The Chancellor of the Exchequer announced today

> ".... to encourage the saving habit further, a new and attractive way to save through National Savings, to be known as the Capital Bond, will be launched at the beginning of next year".

2. Full details of the Capital Bond are contained in a press release issued today by the Department for National Savings.

CONFIDENTIAL

FROM: J A PATTERSON DNS
DATE: 11 OCTOBER 1988

cc; PS/Chancellor
Sir P Middleton o/r
Mr Scholar o/r
Mr Peretz o/r
Miss O'Mara
Mr Rich

Mr Wilson
Mr Hickman Robertson
Mr Watts NSB
Mrs Cullum
Mr Kellaway

ECONOMIC SECRETARY

**DATE OF LAUNCH OF CAPITAL BOND**

1. Miss O'Mara's minute of today said that we would be minuting you separately on the starting date.

2. If Ministers want to go for the earliest possible launch in January there are in practice two dates to choose from.

3. You have already been given 4 January (Wednesday) and 9 January (Monday). If we wished to launch the new product through 20,000 post offices from day one I would argue very strongly in favour of the later day. This is because Monday 9 January is the first day of the first clear week after the Christmas and New Year Bank Holidays. To make matters in the preceding week more complicated Tuesday 3 January is a Bank Holiday in Scotland.

4. If we attempted to have our prospectuses in 20,000 post offices from day one we <u>might</u> be able to achieve a start date of 9 January if Ministers took the decision on interest rates just before Christmas. But there would be a great scramble, and a risk that printers might fail to deliver the prospectus on time. If we followed this route we would in fact by-pass the normal Post Office

distribution system at Swindon and go for some direct distribution to the 20,000 post offices.

5. Swindon have said that we would need to have all of our documents ready well before mid-December for a launch in early January. This is unacceptable.

6. There is however another way of by-passing not only Swindon but the whole of the Post Office network for the first few weeks. We did this for the Indexed-Income Bond, by relying for the first few weeks solely on press advertising which would contain the full prospectus. This enables customers to send a coupon direct to Glasgow, without going to their local post office to get the prospectus and application form.

7. For a launch early in January, as the network is recovering from Christmas and New Year backlog, I am sure that this is the wisest course, and I have dropped a hint to this effect to the Managing Director of the Post Office Counters Business.

8. If we follow this route Treasury Ministers could defer the decision on interest rates until the last possible minute before Christmas. We would then prepare the prospectus and sales leaflet immediately after Christmas. Both of these must contain the interest rate. Our first public activity would be TV and press advertising on and after the date of launch, and the first public sight of the prospectus would be in the press advertisement.

9. I still have a personal preference for Monday 9 January, because the first few days of January are a very busy time for our people in Glasgow. They too have the problem of two Scottish Bank Holidays on 2 and 3 January, leaving them with a rather short working week.

10. Nevertheless if Ministers wish to go for Wednesday 4 January, on the basis that we would sell at first through newspaper coupons and would leave the Post Office network out of things for the first three-four weeks, I am reasonably relaxed about the earlier date.

J A PATTERSON

CONFIDENTIAL

1. Alex
2. PMP

PPS pt [from pre summer]

FROM: J A PATTERSON
DATE: 12 OCTOBER 1988

cc: PS/Chancellor
Mr Peretz (or)
Miss O'Mara
Mr Rich

Mr Wilson ) DNS
Mr Ward ) "

ECONOMIC SECRETARY

**ERNIE STAMPS**

1. Mr Sandy Gilmour, accompanied by Mr Colin Hill, called on Mr Ward and myself this morning at his own request. This was a follow-up to his meeting with you on 26 July and his subsequent call on Mr Rich on 23 August.

2. There seemed to be some doubt in Mr Gilmour's mind whether the Government was mildly in favour of the 'stamps' scheme, or rather neutral or rather opposed. He said that he wanted to know exactly where National Savings stood before he went back to his associates.

3. I said that I had been through the papers in the early 1970s when the National Savings attitude had been initially less than clear. But my predecessors had eventually opposed the scheme, with approval from Treasury Ministers, essentially on the ground that it would annoy the National Savings Committees (since abolished) - a reason which was no longer relevant.

4. I said that a few years ago I might have taken a rather more forthcoming view of the 'stamp' proposals because until quite recently we had marketed the Premium Bond scheme as much to the £5 or £10 minimum purchaser as to those prepared to make a substantial investment. I stressed the distinction between

(a) activities which any private citizen or enterprise was entitled to carry out to buy Premium Bonds (or indeed Premium Bond Gift Tokens) at the normal points of sale, and

(b) special regulations or administrative arrangements designed to benefit particular individuals or groups.

5. I noted that (b) would imply some sort of official approval. I had had no message from Treasury Ministers that I should give such an approval. I made it clear that this was ruled out. If any proposals involved normal use of Post Office Counters, Girobank and/or the clearing banks through which we sell Premium Bonds there could be no impediment from National Savings but I warned eg about changes in the minimum purchase level. Mr Gilmour accepted this. If however the proposals were covered by (a) it did not fall to me as Director of Savings to make any comment at all on such proposals. It was up to Mr Gilmour and his backers to make their own decisions without involving any part of National Savings in either the policy or their administration of a stamp scheme.

6. Mr Gilmour welcomed this clear statement of view. I do not know whether he intends to proceed with a scheme or not. He may wish to leave the decision to his backers, who are clearly looking for the maximum number of what was bound to be £10 or £20 low-level transactions.

7. I said by way of general background:

(a) Treasury Ministers did not regard Premium Bonds as 'good quality' funding

(b) our approach to Premium Bonds in DNS was obviously coloured by the new era of Public Sector Debt Repayment

(c) our marketing now went for the £1,000 - £10,000 'tax-efficient fun investment', not £10 minimum purchases

(d) our cash limits and manpower totals were under a much more severe squeeze than I could recall since I joined National Savings in 1981, and for this reason alone I would not myself want to do anything which led to an increase in the number of small value transactions which was bound to flow from a stamp scheme.

8. Mr Gilmour may well wish to go ahead as in 4(a). But he will now know that his scheme is diametrically opposed to the way we are marketing Premium Bonds to help our cash limit and manpower problems.

J A Patterson

CONFIDENTIAL

FROM: IAN RICH
DATE: 12 OCTOBER 1988

Ch/ This is the promised draft DNS press release. If you are content for them to do it at all,* you or EST will wish to clear.

ECONOMIC SECRETARY

cc PS/Chancellor
Sir P Middleton o/r
Sir T Burns
Mr Scholar o/r
Mr Gieve o/r
Mr Grice
Miss O'Mara
Mr Bush
Mr Hudson
Mr Cropper

Mr Hickman Robertson-DNS

MPW 12/10

* MG and IDT thought this OK (MOM's earlier note on EST PN)

CAPITAL BONDS : DNS PRESS RELEASE

Miss O'Mara's submission of 11 October covered a draft Treasury press release. This explains that full details of the Capital Bond are in a press release issued by the DNS.

A draft of the DNS press release is attached. We have no amendments to suggest, and should be grateful for your agreement as soon as possible. As in the case of the Treasury notice, we shall need to check the direct quotation (paragraph 1, line 2) after the Chancellor has made his announcement.

Allowing time for running off copies of the final versions, this suggests that we will be in a position to issue the press releases simultaneously at about 3.30pm tomorrow.

Ian Rich

IAN RICH

CONFIDENTIAL

**DRAFT PRESS NOTICE**

**CAPITAL BONDS: A NEW PRODUCT FROM NATIONAL SAVINGS**

National Savings' new Capital Bond, announced today by the Chancellor of the Exchequer as a means of further encouraging savings, will be launched early in January 1989. It will replace the Deposit Bond, which will be withdrawn from sale on 19 November, and like the Deposit Bond it will be administered by National Savings in Glasgow.

Capital Bonds are designed to guarantee growth. The interest rates will be set to increase after each year of their five year life in the same way as National Savings Certificates. This will encourage savers to hold their Capital Bonds for the five full years.

Describing the special benefits offered by the Capital Bond, the Economic Secretary to the Treasury, Mr Peter Lilley MP, said that it will combine the guaranteed return also offered by Savings Certificates with interest paid gross but subject to tax.

He saw considerable advantages in this. 'Since the interest is paid gross, those who do not pay tax will continue to receive a return free of all deductions, in line with our continuing policy of providing a home for the savings of the non-taxpayer. That means no tax to pay for many pensioners and, once we move to independent taxation, for many wives too. But at the same time, the tax treatment of the Bond will not involve the Exchequer forgoing top rate tax from higher rate taxpayers.'

'The Bond also offers the individual a much bigger opportunity for investment than the traditional Savings Certificate', he continued. 'We have limited the maximum amount of new money a saver can put in the current savings

certificate to £1,000 to restrict the amount of revenue forgone from investment by higher rate taxpayers. But we have no need to place any limit on individual holdings of the Capital Bond because it will be subject to tax.'

Mr Lilley said that this first new product from National Savings for three years opened up an exciting prospect. He believed it would tap a new market, encourage additional long-term saving and help improve the quality of Government borrowing.

## 34TH ISSUE REINVESTMENT LIMIT DOUBLED

Mr Lilley also announced that on Saturday 15 October the limit on reinvestment from older Savings Certificates into the current 34th Issue would be doubled from £5,000 to £10,000. This was 'with the same aim of encouraging good quality saving', he said. As with Capital Bonds holders of new Savings Certificates have an incentive to hold them for five full years to earn the highest return.

**Notes to Editors**

Details of the new Capital Bond are as follows:

1. Capital Bonds will be issued in Series, denoted Series A, B, C etc. The guaranteed rates for Series A will be announced early in the New Year.

2. Like Savings Certificates the new Bond will earn interest at a guaranteed rate which will go up for each full year the Bond is held until it matures after five years. On each anniversary of purchase the interest will be added to the capital and compounded. After five years the Capital Bond will be repaid automatically and no further interest will be earned.

3. Capital Bonds may be repaid before maturity at three months' notice. Provided they have been held for a year or more, interest will be earned from the date of purchase to the date of repayment. Bonds repaid within a year of purchase will not earn any interest.

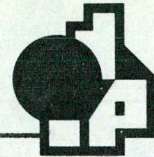
4. The minimum purchase will be £100. There will be no maximum. Capital Bonds may be held by personal savers of any age and by trustees for individuals. They will be available through post offices or by application direct to the Capital Bond Office in Glasgow.

BF ~~26~~/10 30/11

Ch/ Aargh! V bad that no-one in DNS spotted this.

MPW

I thought a number of Bldg Socs issue the term 'Capital Bond'. @ Let Stella have legal advice asap.



**Nationwide Anglia** Building Society

Peter Lilley Esq MP
Economic Secretary to the Treasury
HM Treasury
Parliament Street
LONDON SW1P 3AG


**Principal Office**
Chesterfield House
Bloomsbury Way
London WC1V 6PW
Telephone: 01-242 8822

Chief Executive
**Tim Melville-Ross** FCIS CBIM FRSA



ECONOMIC SECRETARY
REC'D 24 OCT 1988
ACTION Mr Patterson : DNS
COPIES TO PS/Chancellor, Miss O'Mara, Miss Noble, Mr Rich


21 October 1988

TDMR/EJL

Dear Mr Lilley

**NATIONAL SAVINGS**

I read with interest your 13 October press release announcing your plans for what certainly looks as if it will be a very attractive savings product. My concern in writing to you is your apparent intention to use the term "Capital Bond", a trade mark which the Society has used and thought of as its own for many years.

My colleagues confirm to me that the term "Capital Bond" has been in uninterrupted use by Nationwide Building Society and now its successor, Nationwide Anglia, since February 1973. During that period, the Society has maintained exclusive use of the name and a service mark application was made in October 1986 and remains pending.

It is not at all clear from the press release that you have used the term other than in a descriptive sense and it may well be that the new product will have a different name. Bearing in mind the importance of the trade mark to Nationwide Anglia, we would certainly hope that National Savings will choose a different name, once the detailed product has been evolved and is ready for marketing. In the meantime, however, my colleagues take the view that the Society should reserve its position with a view to taking whatever steps may be necessary to maintain what is seen as its own trade mark.

Forgive me for troubling you on this matter but I felt that it would be in the interest of both National Savings and the Society to tell you of our concern as soon as possible with a view to avoiding unnecessary differences at a later date.

With kind regards

Yours sincerely

Tim Melville-Ross


Telex: 264549 NBSGRP G
Telefax: 01-242 8822

cst.pas/mc/2.25.10

FROM: MARK CALL
DATE: 25 OCTOBER 1988

FINANCIAL SECRETARY

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Peretz
Mrs Chaplin
Mr Tyrie

LOTTERIES

The Loto "NHS Lottery" seems to be raising its head again. John Godfrey, special adviser at the Home Office, tells me the Crown Prosecution Service are not certain they can find a point of law on which to stop it this time.

2. The press coverage referred to the scheme as the 'NHS Lottery'. Maybe I am being pedantic, but can they use this name? Have they agreed with the Department of Health or the Treasury that the proceeds may be used by the NHS?

3. If they are allowed to go ahead, we can expect an unholy scramble by the other promoters who have been lobbying away quietly. They have been doing so discreetly because they have been assured that the Loto people would not be allowed to cobble together local lotteries into a de facto national lottery. I was under the impression that Douglas Hurd was to make an announcement which would rule out this approach. In my view such an announcement should be as soon as possible. It may not dissuade Loto Ltd, but at least they should know before they start operating that we intend to outlaw the kind of scheme they are proposing from the year end. For technical reasons they could then carry on until march, giving them 6 months operation in all. Their judgment will probably be that having been operating for 6 months there would be at least some chance of being allowed to continue. I would therefore judge that providing CPS confirm their preliminary advice, they would proceed with or without an early announcement by Douglas Hurd.

4. As a result I think there may be a case for reopening the question of national scale lotteries. It would look pretty odd to have a de facto national lottery operated by Loto Ltd, but forbid reputable and experienced promoters of lotteries form undertaking a national scale lottery.

MC

**MARK CALL**

Saturday, October 22, 1988
NDARD

# ...ttery to win NHS millions

by Michael King

...ti-million pound lottery to raise cash for the ...tional Health Service ...as relaunched today, with organisers hoping it would be second time lucky.

The original Loto UK, run by the National Hospital Trust, came to a sudden end in May this year after the Director of Public Prosecutions said it might be illegal.

Organisers sought legal advice, slightly altered the set-up and today came back with the new format.

Loto UK, a registered charity, offers punters the chance to win prizes totalling £200,000 every week for a £1 stake.

Up to 16 million entry coupons are now being delivered by post but eventually people will be able to punch their entries into computers. The size of lotteries in Britain has been restricted by law, but setting up a number of small lotteries to be lumped together provides the size of prize the organisers say the public demands.

The lottery costs £7,500,000 to run. Of the proceeds 50 per cent will be prizes, 15 per cent running costs and the remaining 35 per cent will go to the Health Service.

] Entertainment Guide 36-43 ☐ Critics 35 ☐ Letters 45 ☐ Patric Walker 46

Daily Telegraph

## NHS lottery plans to sell by computer

By David Fletcher
Health Services Correspondent

A LOTTERY raising money for the NHS, and offering weekly prizes of up to £200,000 for a £1 stake, was launched yesterday after legal problems had delayed its start from last May.

Up to 16 million entry coupons will be delivered to homes in the next few days, and the first draw will take place on Friday week. Its organisers, the National Hospital Trust, expect it to raise more than £17 million for the NHS over the next 12 months, rising to £175 million a year.

If the lottery proves popular they plan to use computer terminals in newsagents, tobacconists and supermarkets to sell tickets.

The size of the weekly prize will depend on the number of people taking part, but is guaranteed to be not less than £50,000. Of every £1 staked, 35p will go to the NHS.

Although the lottery has been given legal clearance by the Crown Prosecution Service its long-term future is uncertain because Mr Hurd, Home Secretary, has said he is planning legislationwhich may outlaw it.

Morning Star

## Revamped NHS lottery 'legal'

A NATIONAL lottery aimed at raising money for the National Health Service has been relaunched.

The organisers withdrew a similar scheme earlier this year after the Director of Public Prosecutions said that it could be illegal.

The new scheme brings together 100 local draws into one national lottery giving prizes worth up to £200,000.

By taking on a representative at each branch and by naming the branches on the tickets, the Crown Prosecution Service said that the scheme would now be legal.

● NHS workers demonstrated against Health Secretary Kenneth Clarke yesterday when he attended a stone-laying ceremony at Newcastle's Royal Victoria Infirmary.

The hospital's dermatology consultant Prof Sam Shuster described the project for a new wing as 'farcical' when the city's health budget is short of £800,000 and three wards are threatened with closure.

TODAY

## Key in to NHS bingo Mark II

A MULTI-million pound lottery to raise cash for the NHS was launched yesterday.

Loto UK offers prizes totalling £200,000 every week for a £1 stake.

Up to 16 million entry coupons are being posted but eventually punters will be able to punch their entries into computer terminals in shops such as newsagents and supermarkets.

A previous Loto UK scheme was suspended in May when the Director of Public Prosecutions said it might be illegal.

The organisers, National Hospital Trust, now have a new format.

They believe it will be a success despite the Home Secretary's threat to outlaw multiple lotteries next year.

The lottery costs £7½ million to run. Of the proceeds, 50 per cent is for prizes, 15 per cent costs and 35 per cent goes to the NHS.

FINANCIAL TIMES

## NHS lottery relaunched

A MULTI-million-pound lottery to raise cash for the National Health Service was relaunched yesterday.

The original Loto UK, run by the National Hospital Trust, came to an end in May after the Director of Public Prosecutions said it might be illegal.

The organisers sought legal advice, and have slightly altered the set-up.

Loto UK, a registered charity, offers the chance to win prizes totalling £200,000 every week for a £1 stake.

EXPRESS

## NHS draw relaunched

A NATIONAL lottery to raise cash for the Health Service was relaunched yesterday with prizes totalling £200,000 every week for a £1 stake.

The first draw was abandoned just before winning tickets were chosen after the organisers were warned that it could have been illegal.

BF 10/11

Good. But we had better get Mr Jacob's advice on substance.

FROM: J A PATTERSON DNS
DATE: 3 NOVEMBER 1988

cc: PS/Chancellor
Miss O'Mara
Mr Rich

Mr Wilson
Mr Hickman Robertson
Mr Kellaway

ECONOMIC SECRETARY

**'CAPITAL BONDS'**

1. This note is to give you advance notice that Counsel (Mr Robin Jacob QC) has given us very robust advice that we should stand firm on our title 'Capital Bond' and oppose the Nationwide Anglia Building Society with vigour if they persist in their application to register the title 'Capital Bond'. He considers the chances of the application being successful to be very remote.

2. Mr Jacob is the authority on trade mark law, and he gave it as his 'very strong recommendation' that we should press ahead with the use of the name. We shall get his written opinion early next week, and advice on the terms of the reply to Nationwide Anglia's letter of 21 October. I shall then submit a draft reply with this advice.

3. This legal advice is very welcome not only because it enables Ministers to go ahead with their preferred product title but also because it accords with common sense and our brushes with the trade mark registration system over recent years.

4. One such brush was the discovery many years ago that the Abbey National had registered 'Granny Bond' as a trade mark. This did not cramp our style because we never used 'Granny Bonds' as an official title. More recently we enquired about the possibility of registering 'Income Bond', and were essentially given the same advice that Counsel has now given us for the Capital Bond.

Income/Capital Bond is too descriptive or general for any one trader to monopolise.

5. After Treasury Ministers decided in favour of 'Capital Bond' we did in fact make a private enquiry of the registration people, and were told literally on the eve of the Chancellor's Brighton speech that Nationwide Anglia had applied to register 'Capital Bond'.

! 6. I took the view that there was no point in passing this information on to the Treasury at the eleventh hour

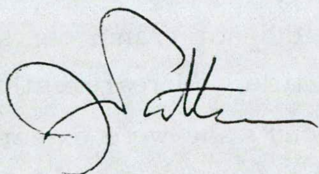
(a) because I thought (wrongly) that Nationwide Anglia were unlikely to try to oppose us when their case was so thin

(b) Treasury Ministers had taken a decision and we should stick to it

(c) the attempt to register an exclusive trade mark was very likely to fail anyway.

7. Our fall-back position would have been a recommendation to you to use the term 'Capital Growth Bond' but not to say anything about it before say 3 January 1989. But the attached advertisement by the Nationwide Anglia may suggest why I should have been particularly irritated to make any concession to that particular building society. It had no difficulty in distinguishing between the National Savings Income Bond and its own Income Bond when it saw a marketing advantage in doing so.

8. Incidentally on Counsel's advice we are now applying to register 'National Savings'.



J A PATTERSON

Enc

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8

NATIONWIDE ANGLIA

# 8.00% NET

INCOME BONDS

NATIONAL SAVINGS

# 6.75% NET

INCOME BONDS

# An announcement of little interest to people with National Savings Income Bonds.

First the bad news.

If you pay tax, as do most investors with National Savings Income Bonds, you're not earning as much monthly income as you could.

And if you unexpectedly need some of your money you will have to wait three months and may even lose some interest (as you can see from the table).

And because National Savings' interest is paid without deducting tax you'll also have the headache of finding the money to pay the tax bill at the end of the year.

[illegible]

Nationwide Anglia's Income Bond pays a higher rate of interest so you'll receive more monthly income *after tax*.

And if you need some money back you can withdraw it immediately with loss of 90 days' interest on the amount withdrawn or give 90 days' notice and you won't lose a penny.

Of course, you don't have to worry about tax at the end of the year. So if you're thinking of investing a lump sum for your monthly income or adding to your existing Bond just call at your local Nationwide Anglia branch.

IncomeBond

**MONTHLY INCOME TABLE**

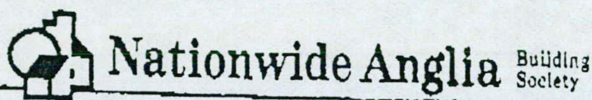
| INVESTMENT | NATIONWIDE ANGLIA | NATIONAL SAVINGS |
|---|---|---|
| £2,000 | £13.33* | £11.25† |
| £5,000 | £33.33* | £28.13† |
| £10,000 | £66.66* | £56.25† |
| £20,000 | £133.33* | £112.50† |
| £50,000 | £333.33* | £281.25† |
| Based on current interest rates, but may vary. Correct at time of going to press | 8.00% NET equivalent to 10.67% gross to basic rate tax payers | 9.00% gross equivalent to 6.75% NET to basic rate tax payers |
| WITHDRAWAL CONDITIONS | Immediate access with loss of 90 days' interest or no penalty with 90 days' notice | 3 months' notice and on withdrawals in first year loss of half the interest earned |

*Paid net of basic rate income tax. †[illegible] basic rate income tax has been paid

Can add to or withdraw from either investment in multiples of £1,000. Minimum investment on either bond £2,000.

And if after choosing your Income Bond you feel it does not match your needs, simply let us know within two weeks. We will happily transfer your money to another Nationwide Anglia account, and the new terms and conditions will apply from the date of your original investment. Or alternatively you can have your money back immediately and without loss of interest.

Just ask. We're here to help you make the most of your money (even if you have a National Savings Income Bond).




Nationwide Anglia Building Society, [illegible] House, Bloomsbury Way, London WC1V [illegible]. Rates may vary. Correct at time of going to press. [illegible] £1000 provided that the balance does not fall below minimum investment of £2000. Withdrawals [illegible] by cheque in just a few days.

pe.sh.misc.tt.3.11

CONFIDENTIAL - COMMERCIAL IN CONFIDENCE

FROM: T TARKOWSKI

DATE: 3 NOVEMBER 1988

1. MR MOORE

2. CHANCELLOR

cc: Financial Secretary
Economic Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mrs Lomax
Mr Gieve
Mr Bent
Mr Call
Mr Tyrie
Mrs Brown (or)

**GIROBANK**

I understand that Mr Newton has arranged to see you at 6.00 to discuss the possibility of making a further statement on Girobank tomorrow afternoon, in response to a priority written PQ from Mr Roger Stott (Wigan). We have also just learned that there is to be an adjournment debate on Girobank next Thursday, though we do not yet know the MP or the motion.

2. We are told that Mr Newton will bring drafts of the proposed Answer and backup briefing with him: DTI officials have not been able to tell us precisely what it is intended that they say. As far as they know the general purport will be that discussions continue but that the Government no longer expect to be able to complete the sale process in November. The aim would be to say just enough to avoid having to make any further statement until after the Steel offer period is over (lists close on 2 December and dealings commence on 5 December).

This is what Mr N's office told me

3. We do not disagree with the aim for a statement of some kind soon, though tomorrow seems unnecessarily rushed. There would be time for more careful consideration of what precisely should be said if we aimed for a statement next week. We see no reason why the Answer to Mr Stott should be the vehicle. DTI officials appear to agree.

<u>State of Play</u> (Annex attached)

4. The current position is not markedly different from my previous reports. There are no formal bids but some - highly tentative - interest. It remains possible that a sale could be effected. The PO Chairman, Sir Bryan Nicholson, is committed to leaving no stone unturned. But this will take substantially longer than envisaged, risks embarrassment through further unguided press speculation or leaks, and may still fail to result in a sale (details of avenues being explored are annexed).

<u>Options</u>

5. The main options appear to be:

i. stick to our present line "discussions are continuing". We do not think this could hold for long now on its own: the Girobank staff will expect an explanation of why they have not yet met potential purchasers.

ii. Say only that the timetable had been extended (the DTI proposal). An elaboration DTI are thinking of is to get Mr Nicholson to write asking for an extension and to refer to this in the PQ.

iii. Announce that the sale is off. Mr Newton presumably feels this is still premature. The risk of deferring any acknowledgement that the privatisation is, or might be, off is that we could be forced to say so <u>during</u> the Steel offer period. Could DTI hold the line at (ii) that the timetable had been extended 6 or 8 weeks <u>even if</u> all discussions have in fact ceased after 3 weeks?

6. Our conclusion would be that there should be some further acknowledgement of the current position next week, but which stopped short of withdrawing from any discussion with potential purchasers. A statement might say something along the lines that this phase of the process was now over

and that, in the light of the criteria, no suitable purchaser had emerged, though discussions were continuing with a number of interests. Government remains committed to privatisation when possible and remains willing to talk to interested purchasers.

7. Supplementary briefing could make it clear that difficulties over Girobank reflected the special circumstances of the Bank and did not imply any lack of appetite for wider equity offerings.

Tancred Tarkowski

**T TARKOWSKI**

**STATE OF PLAY: 3.11.88**

1. Sole Purchasers

The PO/Schroders have more or less given up hope of a reasonable bid. We ruled out HFC (c£60m) and Unity Trust (c£90m). There are still conflicting reports about the latter. If serious, their plans might involve some rationalisation (ie redundancies). The bid approximates to Girobank's net asset value, arguably a more realistic price by comparison with stockmarket valuation of other banks than the earlier bids at around £170m. But sale at such a price might be criticised as cut-price following the currency which higher figures have had. Hambros (our advisers) are separately in discussion with Australian National Bank. Barclays are said to be interested, but this would call in question the criteria of safeguarding employees' interests and increasing competition, which the PO Board and Mr Newton would find difficult. Schroders think a retained PO stake could aid sale, and the price, by demonstrating a practical commitment on PO's part, but this would be an obvious compromise solution.

2. Consortium

Credit Argicole have walked away. But Next and Midshires Building Society are said to be keen. The missing link is a bank (necessary to satisfy both the Bank of England and the Building Societies Commission). Schroders and Charterhouse (the midwife to the consortium idea) have more or less given up hope of a bank if talks today with Standard Chartered yield nothing. They have also raised the question of a PO stake as possibly satisfying the regulatory authorities instead. Hambros (advising us) are more optimistic. They believe that Schroders have been insufficiently active and (as with sole purchaser ideas) want to explore more widely and under less pressure of time. If this is accepted the PO may want to agree formally with Government that it should cast its net wider (and/or relax the criteria originally agreed with Mr Newton). Any wider enquiries seem to point to the need for a rather fuller statement next week than we expect Mr Newton to propose.

[passed on] MP

FROM: J A PATTERSON DNS
DATE: 9 NOVEMBER 1988

cc: PS/Chancellor ) with encs
Miss O'Mara )
Mr Rich )

Mr Wilson )
Mr Hickman Robertson ) without encs
Mr Kellaway )

Agreed.

Ch/ I think draft letter is a bit over the top*. Some softening amendment suggested. MPW.

*not least because, I think its the Chairman of Nationwide Anglia who is officially hosting yr dinner on 17/11.

ECONOMIC SECRETARY

**'CAPITAL BONDS'**

1. In my minute of 3 November I said that Counsel (Mr Robin Jacob QC) had given us very robust advice that we should stand firm on our title 'Capital Bond'.

2. I now enclose his Opinion, which says

> 'DNS are entirely free to proceed with their plans'.

3. I also enclose a draft by Mr Jacob for you to send to the Chief Executive of Nationwide Anglia. It is written in the most uncompromising terms, which apart from editorial changes I have not amended at all except to add a reference to the 'Ecclesiastical 10 year Capital Bond', which as far as we know was launched in the last few days and is being very heavily advertised. Their Sunday Times advertisement is attached.

4. Incidentally we have heard informally that the Stroud and Swindon are withdrawing their Capital Bond (not because of a protest from Nationwide Anglia but as far as we know because it was a 'Limited Issue' and they have presumably taken in as much money as they wanted from it).

5. I hope that you will be prepared to write to the Chief Executive of Nationwide Anglia as advised by Counsel.

J A PATTERSON

3 encs

**DRAFT LETTER FOR THE SIGNATURE OF THE ECONOMIC SECRETARY TO TIM MELVILLE-ROSS ESQ FCIS CBIM FRSA, NATIONWIDE ANGLIA BUILDING SOCIETY, CHESTERFIELD HOUSE, BLOOMSBURY WAY, LONDON WC1V 6PW.**

I was surprised by your letter of 21 October 1988 in which you expressed concern over the use by National Savings of the name "Capital Bond". The idea that anyone could suggest that such a descriptive name could be a trade mark of one enterprise only never crossed my mind or the minds of anyone concerned with the new National Savings product. I adhere to that view now that my advisers have looked into the matter further.

Accordingly National Savings will proceed with the issue of their capital bond in January under that description as planned. The issue has already received widespread publicity and it would be commercial nonsense now to use any other name. As you correctly suggest in your letter the name is being used by National Savings in a descriptive sense. I think it is a very apt description. If it had been a trade mark as you allege then, having regard to the widespread publicity, some confusion would surely have already resulted. None has.

I am bound to say that, despite your claim that the name is a trade mark, it appears to me that you too have used the name descriptively. Thus your brochure says 'Capital Growth....Your investment will show a really healthy rate of capital growth'. Similarly you use the expression 'Income Bond' for another product, as do National Savings. Indeed you have in the past indulged in comparative advertising over this product. I enclose a copy of one of your recent comparative advertisement. I do not see how you can accept 'Income Bond' as descriptive but claim 'Capital Bond' to be a trade mark.

I note you claim exclusive use of the name. In fact others do use it. For instance I enclose a copy of the October 1988 brochure of the Stroud & Swindon Building Society who offer a capital bond product. I quote from page 23 of the Arthur Andersen brochure of 1985 called 'Tax efficient personal investment', which clearly shows that the name is descriptive:

'Building society deposits

'(d) Term shares (also referred to as high income bonds, high yield bonds, capital bonds)'....

I understand from your letter that you have a service mark application pending for the words 'Capital Bond'. Presumably that is No. 1,277,064. If you decide to pursue this further I trust you will bring our correspondence and the enclosures to this letter to the attention of the Registrar.

I would only add that I too hope that there will not be unnecessary differences at a later date. ~~If there are, they would be the result of Nationwide Anglia's attempt to monopolise wholly descriptive words.~~

I have also noted in the last few days a campaign by the Ecclesiastical Insurance Group promoting a ten year 'Capital Bond'. I enclose a copy of the advertisement which appeared in the Sunday Times on 6 November.

OPINION

I am asked to advise the Department for National Savings ("DNS") in relation to the complaint by Nationwide Anglia concerning the adoption of the name "Capital Bond" to describe DNS' new savings product.

I have formed the clear view that Nationwide have no justification for their complaint. DNS are entirely free to proceed with their plans. The expression is not open to the monopoly of any one enterprise. I turn to consider the matter in a little more detail.

Two potential legal claims fall to be considered: passing off and infringement of a registered service mark. So far as passing off is concerned it is essential, inter alia, that the plaintiff proves that the defendant is making a false representation which damages the business or goodwill of the plaintiff. Here that is impossible. No-one thinking of investing with Nationwide Anglia could conceivably be be misled by the name into investing with DNS. People are not that stupid.

It is fair to note that Mr. Melville-Ross' letter dated 21st October 1988 on behalf of Nationwide Anglia does not suggest passing off. He speaks of "unnecessary differences at a later date" thereby indicating an intention to rely upon Nationwide Anglia's pending application for registration as a

service mark of the words "Capital Bond." If, indeed, such a registration was validly obtainable, Nationwide might have an arguable case, though even then DNS would probably have a defence under s.8 of the Trade Marks Act 1938 that their use was a bona fide description. However I have formed the firm view that no registration is obtainable.

Under the Act registration is refused unless the mark is distinctive (s.9 for Part A) or capable of distinguishing (under s.10 for Part B). There is much authority on these two sections. It is now settled that registration cannot be obtained for essentially descriptive words or expressions. The reason is the clear policy that one trader should not obtain a monopoly over words which others might reasonably and honestly want to use in their trade. That is the case with the words "Capital Bond". Not only do DNS so want to use it (in contrast to their "Income Bond") but others do so. I have before me the brochure of the Swindon and Stroud B.S. which so uses it now and an Arthur Anderson information booklet of 1985 which clearly shows that the word is used as a description. Others may have used it in the past, though I would not be particularly surprised if some have desisted on complaint from Nationwide - a threat (or indeed informal request) is often complied with even where it has no legal foundation.

In my view the mark is so descriptive that it should and almost certainly will be refused by the Registrar of Trade Marks without even proceeding to advertisement. However that

department is so overloaded with work under the new service mark system that one cannot be sure. Accordingly I advise that the letter of reply to Mr. Melville-Ross should itself ask him to draw the correspondence to the attention of the Registrar if the application is to be pursued. In the most unlikely event that the mark does proceed to advertisement then DNS should oppose registration. Such an opposition would prevent any possibility of legal action for at least several years.

In discussing such legal action here, I wish to make it plain that I regard the matter as theoretical. For the reasons I have given Nationwide have not and will not get any relevant rights.

Robin Jacob

The Temple,
4th November 1988

est.ld/james/044

FROM: S M A JAMES
DATE: 15 November 1988

MR PATTERSON - DNS

cc: PS/Chancellor 2
Miss O'Mara
Mr Rich

Mr Wilson - DNS
Mr Hickman-Robertson - DNS
Mr Kellerway - DNS

CAPITAL BOND

The Economic Secretary was grateful for your minutes of 3 and 9 November.

2. He would prefer to write to Nationwide Anglia along the lines of the draft attached. I would be grateful to know if you have any difficulty with the revisions.

3. The Economic Secretary is relieved to know that there is no legal difficulty over the use of the title capital bond as he was unaware before Nationwide Anglia wrote to us that there might be a problem over the use of the name.

S M A JAMES
PRIVATE SECRETARY

est.ld/james/044

Tim Melvill-Ross Esq
Nationwide Anglia Building Society
Chesterfield House
Bloomsbury Way
LONDON
WC1V 6PW

November 1988

Thank you for you for your letter of 21 October 1988 in which you expressed concern over the use by National Savings of the name 'Capital Bond'.

I am advised that there is no impediment in trade mark law to National Savings using the name National Savings Capital Bond to describe their new product. Accordingly National Savings will proceed with the issue of their capital bond in January as planned.

The name capital bond has already been adopted by others.
... I attach a copy of Stroud & Swindon Building Society's October 1988 brochure which refers to their capital bond. I have also noted a recent campaign by the Ecclesiastical Insurance group promoting a ten year capital bond. I enclose a copy of the advertisement which appeared in the Sunday Times on 6 November.

As you correctly suggest in your letter, the name capital bond is

a generic, descriptive term. Nationwide Anglia's own advertisements use the term capital bond in this way. Your brochure includes the words "Capital Growth... Your investment will show a really healthy rate of "capital growth".

The Arthur Andersen brochure of 1985 "Tax efficient personal investment" clearly indicates that the name is descriptive. It refers on page 23 to "term shares (also referred to as high income bonds, high yield bonds, capital bonds).."

Another of National Savings' products is the Income Bond. You have your own income bond and I note that you use this term generically in your advertisements comparing Nationwide Anglia's product with the National Savings' income bond. The use of 'capital bond' is also descriptive and open to general use.

**PETER LILLEY**

FROM: J A PATTERSON

DATE: 16 NOVEMBER 1988

cc: PS/Chancellor
Miss O'Mara
Mr Rich
Mr Wilson
Mr Hickman Roberson
Mr Kellaway

PS/ECONOMIC SECRETARY

**CAPITAL BOND TITLE**

1. Your minute of yesterday. I think that with one essential addition the draft response to Nationwide Anglia will do enough to indicate to them that we are ignoring their attempt to be monopolistic. But the draft offered by Mr Robin Jacob QC made it rather clearer that we did not think that they had a legal leg to stand on.

[It was impossibly rude - as you will recall!]

2. The 'essential addition' as I see it is the request to bring the Economic Secretary's reply to the attention of the Registrar. This will indicate that we shall be prepared if necessary to oppose the service mark application. (Incidentally we have now found a Scarborough Building Society Solid Gold Capital Bond - Nationwide Anglia have not had much recent success with their monopoly.)

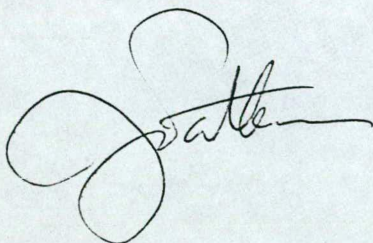
3. So I suggest the addition of a final paragraph:

> It may be that you will be considering whether to pursue your service mark application for the words 'capital bond'. If you do decide to pursue it I trust you will bring our correspondence and the enclosures to this letter to the attention of the Registrar.

4. Our legal advice and the proliferation of other people's Capital Bonds makes it clear that the legal problem (if it exists) was purely one of Nationwide Anglia's own making. As a postscript to this minute I should note that it was essential to have a name for the new product when the Chancellor launched it on 13 October. As the dispute over the tax treatment in the press shows we would have been open

[hmm...]

to ridicule in the press if we had attempted to back off the title decided by Treasury Ministers when we heard the day before the Chancellor's speech that Nationwide Anglia were attempting to registrar the same title. Our press people just could not have said in response to the question 'What will we call it?' that no decision had yet been reached.



J A PATTERSON

mom/pa.199 CONFIDENTIAL MP PPS PE → Alex

FROM: MISS M O'MARA
DATE: 17 November 1988

MLS 17/11

1. MR SCHOLAR

2. ECONOMIC SECRETARY

cc: Chancellor
Sir P Middleton
Sir G Littler
Mr Monck
Mr Moore
Mrs M E Brown
Mr Grice
Mr Inglis
Mr Bent
Mr Rich
Mr Tarkowski
Miss Swift
Mrs Chaplin
Mr Patterson - DNS
Miss Wheldon - TSD

**FUTURE OF NATIONAL SAVINGS ORDINARY ACCOUNT**

Following your meeting on the possible privatisation of the National Savings Ordinary Account, I sent you on 20 September a draft letter to the Chancellor of the Duchy, outlining the possibility of offering the Ordinary Account for sale to Girobank, once Girobank had itself been privatised. You were concerned about the propriety of considering the option of a sale to Girobank alone rather than an open tender and received comments on this from both PE (Mr Bent's submission of 30 September) and DNS (Mr Patterson of 4 October). However, the prospects for the Girobank sale became increasingly uncertain and on official advice, the letter was never sent. We now need to consider how to take matters forward.

2. The extension of the sale timetable for Girobank has now been announced publicly (Mr Tarkowski's minute of 3 November to the Chancellor, copied to you, sets out the background). Given this, we clearly cannot rely on being able to make a quick approach to a newly privatised Girobank. After discussion with PE, we see three options for the future of the Ordinary Account:

i. sale by open tender to any interested party (which could include Girobank, if privatised by then);

ii. transfer to the Post Office (if the Post Office agreed);

iii. managed decline.

We assume, in the light of your earlier discussion with us, that you do not want us to pursue further at this stage the possibility of outright abolition of the Ordinary Account.

Sale by open tender

3. We discussed this option with you in September. Our difficulty is to identify with any certainty a potentially serious purchaser. (Even Girobank may not be interested.) The Government will only wish to proceed with a sale, if the buyer also takes on responsibility for the 40 million dormant Ordinary Account holdings but it is this which makes the potential purchase unattractive, particularly if tax relief were withdrawn from all Ordinary Account investments, once the Ordinary Account entered the private sector. (These considerations would, of course, weigh as heavily with Girobank as with any other potential purchaser.) We should not want to put the Ordinary Account business out to tender only to discover that no one was interested in making us an offer.

Transfer to Post Office

4. If it appeared inevitable that the Ordinary Account would have to stay within the public sector, transfer to the Post Office at first sight appears to offer the opportunity for some rationalisation. The Post Office might be persuaded to integrate the Ordinary Account with Girobank (if it remained in the public sector).

5. However, when the possibility of integrating the Ordinary Account with Girobank has been considered in the past, it has been concluded that the two operations are currently too disparate and the technology too incompatible to make this a simple operation. Moreover, taking on a vast number of Ordinary Account customers would run quite contrary to Girobank's current strategy of upgrading the quality of its business. PE would not recommend a transfer merely as a solution to the Ordinary Account problem. They would want to be persuaded that transfer produced genuine commercial advantages for the Post Office.

Managed decline

6. This is the policy we are currently pursuing. If you wished to accelerate the process, there are a number of steps we could consider, some of which Mr Rich is outlining in a parallel submission. Lloyds' recent decision to pay interest on their "Classic" current accounts could well hasten the decline of the Ordinary Account in any case, particularly if the move were followed by other clearing banks. (The rate Lloyds intend to offer is above that currently paid on Ordinary Account (below £500) for the basic rate taxpayer, even with the £70 tax exemption.)

Assessment

7. None of these options could be introduced quickly. The first two would require primary legislation, for which a slot would have to be secured. The timetable for the third would inevitably be long drawn out, even if we attempted to hasten the process.

8. In an ideal world, it would clearly be helpful if we could commission a full study of the commercial potential of the Ordinary Account business and the feasibility of the options identified. Mr Rich discussed this possibility in his minute of 12 September and concluded that it would not be sensible to call in outside consultants because of the risk of disruption to National Savings business in Glasgow and elsewhere. As you know, the Glasgow staff are already extremely suspicious of the interest expressed by the group of Scottish businessmen led by Sir Iain Noble.

9. However, it would be possible to conduct a more limited study in-house, looking in isolation at the commercial potential of the Ordinary Account, through the use of CA division here. They would be happy to take on the task. (You may recall they undertook a similar study of HMSO about 6 months ago.) It would probably take them only about two weeks to produce a report, once commissioned. While the resulting study could not, of course, be as detailed as one produced by outside consultants under favourable conditions and could not examine any possible economies available from transfer to the Post Office, the Treasury think it would certainly be worth having.

10. DNS fear that senior management in Glasgow would learn of the study and conclude that the National Savings Bank was being considered for privatisation. However, CA could talk to senior DNS management in confidence, in London rather than Glasgow, and the Treasury see no reason why the existence of the exercise should leak.

Conclusion

11. None of the options is very attractive. However, if you see value in pursuing either an open tender or consulting the Post Office on the attractions of transfer to them, despite the difficulties we have identified, the Treasury would recommend commissioning a CA study first. (If you were interested in pursuing the option of sale by open tender any further, we should need to check with DTI's lawyers that it did not raise any problems of disclosure in relation to the Girobank sale.)

12. This submission has been agreed with PE and CA Divisions. However, as indicated above, DNS see major difficulties in even the limited study we propose. They have a strong preference for the third option.

13. How would you like us to proceed?

MOM

MISS M O'MARA

FROM: J A PATTERSON
DATE: 21 NOVEMBER 1988

cc: PS/Economic Secretary
Miss O'Mara
Mr Rich

Mr Wilson
Mr Hickman Robertson
Mr Watts NSB
Mrs Cullum

Thanks. Tom.

PS/CHANCELLOR

**CAPITAL BOND CERTIFICATES**

1. It has been suggested to me that the Chancellor might like to see the new Capital Bond 'investment certificate' which we shall be using as from 4 January 1989. I think that this is particularly appropriate since the Chancellor gave the new Bond a high-profile start in life by announcing it at the Conservative Party Conference.

2. So I enclose a copy of the new investment certificate. For comparison I also enclose copies of the comparable certificates for Income Bonds and Savings Certificates, which belong to an earlier era - the forms review and move to computer-printed documents of the early 1980s.

3. Views on design matters are bound to be somewhat subjective. But it is safe to say that the Income Bond and Savings Certificate design (both done in-house in National Savings) are rather short of a National Savings family feeling.

4. For this and other reasons we asked a private sector firm (Wolff Olins) to design a new family of investment certificates, which would (a) give prominence to the product title and (b) establish very clearly that it comes from National Savings.

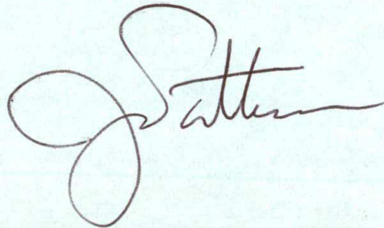
5. The Capital Bond document represents two firsts:

(a) it is as far as I know the first National Savings product document done for us by private sector designers

(b) it is the first of the new 'family'.

Other product documents will use the same design with their own product heading and their own colour scheme.

6. A foot-note on signatures. Research indicates that customers like the investment certificates to be signed. The Permanent Secretary to the Treasury signs the Savings Certificates as Accounting Officer of the National Loans Fund. The Director of Savings signs Income Bonds, Capital Bonds etc. under powers delegated by the Treasury.



J A PATTERSON

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CONFIDENTIAL

FROM: J S HIBBERD

DATE: 22 November 1988

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Paymaster General
Financial Secretary
Economic Secretary
Sir P Middleton
Mr Anson
Sir T Burns
Sir G Littler
Dame A Mueller
Mr Byatt
Mr Monck
Mr Scholar
Mr Culpin
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Turnbull
Mr S J Davies
Mr Gieve
Mr Melliss
Mr Mowl
Mr O'Donnell
Mr Pickford
Mr Bush
Mr Owen
Ms Chaplin
Mr Tyrie
Mr Call
JD/0004

## NATIONAL INSTITUTE ECONOMIC REVIEW

The November National Institute Economic Review comes out at 9pm on Wednesday 23 November, and may feature in that evening's late new bulletins. It will receive detailed coverage in Thursday's press. It contains the Institute's latest forecasts for the UK and world economies. The Review, including one of the special articles, is perhaps more contentious than recent issues. The medium term outlook is predictably gloomy, and the Appraisal section revives the funding policy debate. It may attract considerable comment and this brief is correspondingly more comprehensive than usual.

2. The main features of the new forecast are:-

- GDP growth (output measure) of 5½ per cent in 1988 (6 per cent excluding oil), slowing to only 2½ per cent in 1989 (2¾ per cent excluding oil).

- RPI inflation of 6¼ per cent by 1988 Q4 and 5¼ per cent in 1989 Q4.

- current account deficit of £13 billion in 1988, rising to £15 billion in 1989.

- a PSDR of £11½ billion in 1988-89 and £15½ billion in 1989-90.

**THE FORECAST IN DETAIL**

3. The main features of the forecast (compared with the Autumn Statement forecast) are set out below.

| | NIESR Forecast November 1988 | | Autumn Statement November 1988 | |
|---|---|---|---|---|
| | 1988 | 1989 | 1988 | 1989 |
| per cent change on previous year | | | | |
| Gross domestic product | 5.4 | 2.6 | 4½* | 3* |
| Consumers' expenditure | 5.7 | 2.7 | 5½ | 3½ |
| General government consumption | 0.5 | - | ½ | - ½ |
| Fixed investment | 9.3 | 6.5 | 12 | 5½ |
| Change in stockbuilding (as percentage of GDP) | 0.2 | -0.2 | - | - |
| Exports of goods and services | 1.6 | 6.7 | 1½ | 5½ |
| Imports of goods and services | 12.3 | 6.7 | 12 | 4½ |
| Manufacturing output | 7.1 | 3.0 | 7 | 4½ |
| World trade | 5.4 | 6.0 | 8¾ | 6½ |
| RPI in Q4 | 6.3 | 5.3 | 6¼ | 5 |
| Current account (£ billion) | -13.1 | -15.2 | -13 | -11 |
| PSDR (£ billion financial year) | 11.6 | 15.5 | 10 | |

* GDP average measure.

4. NIESR base their main forecast on the following set of policy assumptions:-

- a 1989 budget which is demand neutral

- unchanged public authorities real consumption between 1988 and 1989

- 4½ per cent a year sterling depreciation, which they see as consistent with maintaining interest rates at current levels.

Aggregate demand and activity

5. The growth in **consumer spending** over the last two years, and the fall in the **savings ratio,** is largely attributed to the growth in consumer credit following financial deregulation. Growth in **real personal disposable income** in 1989 is expected to slow to 1¼ per cent compared to the recent annual average of 3 per cent. This mainly reflects rising inflation, their assumption of no cuts in personal taxation in the 1989 Budget, and a slow-down in earnings growth due to a stand-still in employment. Falling net interest receipts (accentuated by consumer credit continuing to expand faster than income growth in 1989) are also expected to moderate real income growth. Consumer spending is expected to rise by 2¾ per cent in 1989 (only 1¼ per cent between 1988 Q4 and 1989 Q4). This is still faster than real disposable income and the savings ratio continues to fall throughout next year, to 1¼ per cent by the fourth quarter.

6. **Business investment** growth is buoyant in 1988 (manufacturing up 14½ per cent, distribution, financial and business services up 11½ per cent). This is largely explained by recent high profitability and capacity shortages. **Manufacturing investment** is expected to show further strong growth next year (almost 14 per cent). **Other business investment** is projected to decelerate to under 7 per cent, still fairly high. Against this background, capacity shortages are expected to ease in 1989. **Private housing investment** slows from 19½ per cent in 1988 to about 4 per cent in 1989. **Stockbuilding** adds ¼ per cent to GDP in 1988 and -¼ per cent in 1989.

7. **Total domestic demand** is projected to grow by 5½ per cent in 1988 and by 2½ per cent in 1989. Domestic demand decelerates particularly sharply though next year; it rises by under 1½ per cent between 1988Q4 and 1989Q4.

8. The Institute foresee growth of 2¼ per cent for **exports of goods**, a touch higher than the 2 per cent in the Autumn Statement. (This is against the background of an unexplainedly low projection of world trade growth of 5½ per cent. Other forecasters' views range from the 7½ per cent predicted by the IMF and Bank of England to 8¾ per cent in the Autumn Statement.) **Manufactured exports** are forecast to rise by 6 per cent. For 1989 total goods exports are expected to rise by 7½ per cent and manufactured exports by 8 per cent. (Total world trade grows by 6 per cent.) This is a little faster than the Institute's equations would suggest and appears to reflect their judgement that the secular decline in UK export market share has halted, and may even have reversed.

9. **Imports of goods** are expected to rise by almost 13 per cent in 1988 (16½ per cent for manufactures), but to slow down to 7 per cent in 1989 (8½ per cent for manufactures). This is mainly based on their judgement that capacity constraints will ease as the pressure of demand abates. Nonetheless the Institute make a particular point that their forecast of import growth through 1989 is still 2 per cent faster than the AS forecast, and is one of the main differences between their outlook and the Treasury's.

10. The Institute forecast the **output measure of GDP (GDP(O))** rather than the average estimate (GDP(A)), on the grounds that GDP(O) is a more reliable short term indicator. However, they assume that the recent sharply rising discrepancy between GDP(O) and the expenditure measure (components of which are still the fundamental basis for their forecast of aggregate activity) makes no further contribution to growth in 1989 and beyond. (This contrasts with the Autumn Statement where we extrapolated a rising statistical adjustment between GDP(E) and GDP(A), worth ¼ per cent in 1989.) The Institute's forecast for GDP(O) growth in 1989 (2½ per cent) may, therefore, be a little low.

## The current account

11. The current account forecast is mainly driven by the outlook for export and import volumes outlined above. The **visible balance** is expected to deteriorate by almost £2 billion in 1989, from a deficit of £18.7 billion in 1988 to a deficit of £20.5 billion in

1989. (The equivalent AS forecast was an improvement of £1½ billion, from -£18½ billion to -£17 billion.) The **invisible balance** also deteriorates slightly, from a surplus of £5.7 billion to £5.3 billion. This is partly accounted for by the reduction in the net wealth of UK residents as a result of the large current account deficit in 1988, and the associated subsequent reduction in the interest, profits and dividends surplus. Their invisibles forecast compares with an AS forecast improvement from £5½ billion to £6 billion. Overall, the Institute see a worsening **current account deficit** in 1989, to £15.2 billion. They note that a current account deficit of 3 per cent of GDP is not unprecedented (1947 and 1974 were in fact larger). Two successive years of such deficits, however, would be unprecedented.

<u>**Inflation**</u>

12. The section on wage inflation is a mash. The authors seem to switch indiscriminately between settlements and earnings, always failing to match the right figures to the right concept. But in essence their point is a simple one. Some part of the recent increase in **earnings and settlements** reflects increased pressure of demand in the labour market. This pressure will abate with the slow-down in output and demand growth, and earnings growth should also moderate. The Institute helpfully suggest that the **consumer expenditure deflator** is a better indicator of underlying inflation than the RPI because it excludes the cost of housing finance; it is expected to rise to 5-5½ per cent in 1989. **Retail price inflation** itself is expected to peak at over 7 per cent in early 1989, falling back to 5-5½ per cent by the fourth quarter.

<u>**PSDR**</u>

13. The Institute see the PSDR rising to £15½ billion in 1989-90. They note:

> "So long as expenditure is kept under control, even a relatively modest rate of economic growth will generate an excess of revenue. If the authorities are unable to cut tax rates because the indicators point to need for restraint, then the surpluses will mount."

## Employment and unemployment

14. Given the forecast movements in output, the Institute see total employment stabilising between 1988 and 1989 with unemployment remaining at 2.2 million (UK adult, seasonally adjusted, excluding school leavers) over the next year.

## MEDIUM TERM PROSPECTS

15. As usual, the Institute present a medium term outlook. Interest rates are held indefinitely at their late 1988 and 1989 levels, with roughly constant nominal differentials relative to world interest rates. Along with their medium term forecast of slowly falling inflation (consumer expenditure deflator inflation falls from 5.2 per cent in 1989 to 3.6 per cent in 1992), this implies rising real interest rates throughout the period.

16. Against this background, GDP growth falls to 1-1½ per cent in 1990 and 1991, picking up to 2¼ per cent in 1992. Consumer spending is particularly sluggish; by 1992 it is no higher than in 1989 (it actually falls ½ per cent in 1991). Investment growth is also muted, averaging 1 per cent a year over 1990-1992. Net exports pick up but the current account deficit (though slowly declining) remains at around 2½-3 per cent of GDP over the whole period. Unemployment rises to 2½ million by 1992.

17. With regard to financial balances, the personal sector remains in substantial deficit, with net interest receipts continuing to fall. The company sector runs a small surplus. The counterpart to these balances (and the overseas deficit) is a large public sector surplus averaging 2½-2¾ per cent of GDP. But the balance of payments constraint precludes any tax cuts at any point over the three years 1990-1992. The Institute note that this pattern of financial balances necessitates a new pattern of transactions to accommodate them:

> "If the long-term debt of the public sector is repaid, pension funds and similar institutions will be looking for alternative assets, perhaps overseas, perhaps in the property market at home."

## THE INSTITUTE'S APPRAISAL

18. The Appraisal section normally attracts some press comment. It points to the need to reduce unemployment by a sustained period of high investment to rebuild capacity. This is suggested as one reason "... **why deflation through higher taxes would be better than deflation through higher interest rates"**. It also highlights the prospect of sustained current account deficits over the medium term and the need to finance them by capital inflows. The private sector needs to borrow, but overseas investors **"may have a limited appetite for UK equities"**. The banking system may be able to mediate between the overseas and domestic private sectors, but not **"without risk to itself and probably not at a level of interest rates which borrowers would be prepared to pay"**.

19. The Institute go on to draw contentious policy implications by reviving the debate on funding policy. They clearly favour over-funding because:

(a) more long-term gilts would give overseas investors the opportunity to invest in sterling, and would also prevent domestic institutions looking overseas for fixed interest assets;

√ Why is this good?

(b) it would tend to straighten out the yield curve, preventing it from being so downward sloping.

20. Neither of these arguments are original and they are certainly not convincing:

(i) there are still around £140 billion of gilts outstanding. A potential investor in sterling who wants to buy some would have no difficulty provided he is prepared to pay the market price. What the NIESR proposal comes down to is increasing the supply of long gilts so as to make it easier for him to do so, in the sense that he pays a lower price and receives a higher yield. NIESR see no difficulty with this - it likes the idea of straightening out the yield curve. But it is not at all clear why this is sensible; indeed

(ii) over-funding is inherently distortionary. It pushes up long rates, penalising longer term borrowing, and holds shorter rates down, providing a subsidy to shorter borrowing. This is the opposite of what is desirable on monetary policy grounds. One of the beneficial consequences of the reduced public sector demands on sterling capital markets has been the re-emergence of non-government sterling issues. Some £9½ billion of such fixed rate money has been raised in 1988 to date. These issues, of course, are all available to potential sterling investors averse to equities or deposits. But following the NIESR prescription of returning to overfunding would act to choke off such issues.

**OTHER ARTICLES**

21. There are a number of other articles. The only one of importance, because of a possibly sensitive policy implication, is that by **John Ermisch - "Economic Influences on Birth Rates"**. It indicates that higher net real wages for women discourage child-bearing, because its cost (to women) is thereby increased, while higher net real earnings for men (representing higher family incomes) have the opposite effect. His work purports to show that more generous child allowances would raise the birth rate by raising completed family size and encouraging early motherhood, and he advocates a doubling of the current level of child benefit to raise fertility to the level necessary to replace the population in the longer term. His work also indicates that higher house prices deter the start of child-bearing.

22. John Ermisch is a noted expert in his field, but he places too much confidence in his econometric results, which should only be regarded as tentative. The results on the effects of higher child benefit are particularly weak. There is indeed a problem of how to support the larger number of old-age pensioners in the next century if the birth rate does not rise now towards the replacement level, but there are several ways of resolving this problem, in particular encouraging growth in productive investment so as to sustain higher levels of income growth over the longer term. Raising child benefit would be very expensive, and its effect on the birth rate by no means certain.

Line to take on forecast

Positive - Note slow-down in domestic demand growth in 1989 and the moderation in inflation by 1889Q4 are consonant with Autumn Statement.

Defensive - **Current account worsens in 1989?**

Institute themselves note good trade performance; UK export share in world markets stabilised, may even have improved. Slower growth in domestic demand and increased capacity relative to demand should ensure low import growth and improved current account next year.

- **Medium term prospects gloomy; continuing large current account deficits, slow growth, rising unemployment, inflation moderating only slowly, continued high and rising real interest rates.**

Medium term forecasts more hazardous than short-term forecasting. The Institute itself in an article in the November 1987 Review (The British Economy Since 1979), notes how wrong and uniformly pessimistic its medium term projections turned out to be.

- **Tax cuts in 1988 Budget and subsequent high interest rates wrong. Institute call for deflation by higher taxes rather than high interest rates which deter investment.**

No. Tax policy designed to improve long-term supply side. Provides right background for risk taking and innovation. High interest rates necessary to curb inflation, which is major danger to sustained growth.

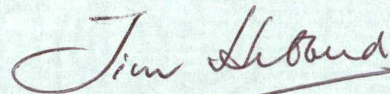
## Line to take on over-funding

### Should return to overfunding, as NIESR advocate?

Overfunding abandoned in 1985 because it introduced distortions into financial markets. Undesirable in themselves and made policy harder to operate. Kept long-term interest rates above what they would otherwise have been and short-term rates probably below. Inhibited companies from issuing long-term debt and increased their reliance on short-term borrowing from banks or, via commercial bills, from Bank of England.

### Over-funding would help sterling?

What matters for sterling is that investors have confidence in Government's policy, which they have. Plenty of opportunities for longer term investment. Active market in £140 billion plus of gilts still outstanding. Further £9½ billion of non-government fixed rate sterling raised in 1988 to date above.



J S HIBBERD

chex.ps/mw/10 **UNCLASSIFIED**

FROM: MISS M P WALLACE

DATE: 22 November 1988

**MR HIBBERD**

cc Sir T Burns

**SAVINGS RATIO**

... The Chancellor would be grateful for a brief note on the attached article by Tim Congdon, from today's Times.

MOIRA WALLACE

THE TIMES

## Commentary • TIM CONGDON

# Some saving graces

Among the many shared anxieties of the Thatcher government and the new Bush administration, one of the most topical is that the British and American people suffer from innate financial prodigality.

The evidence seems to be that both nations are woefully reluctant to save. Last year the personal savings ratio in the US was 3.9 per cent and in Britain 5.6 per cent, whereas in Japan it was 16.6 per cent, in France 13 per cent and in West Germany 12.2 per cent. There is a definite contrast between the English-speaking nations and the rest of the industrial world.

The low savings ratios in the English-speaking nations have been seen as the main culprits for their large external payments deficits. Different savings behaviour can therefore be identified as an important reason for continuing turbulence in the foreign exchange markets.

No wonder that at international financial gatherings the Germans and the Japanese have begun to point an accusatory finger at the inadequacy of American personal savings. Now that the US budget deficit (when expressed as a share of national product) is not much different from international norms, the surplus nations need to open a new flank of criticism.

There is an unspoken theme in international discussion that people whose first language is English are inherently more financially feckless than their Teutonic and Oriental counterparts, almost as if a shared appreciation of Shakespeare and apple pie were responsible for a wider circulation of credit cards.

There is also an implicit belief that savings are virtuous and to be increased, while consumption is wicked and should be reduced.

The truth is more complex. Much of the contrast between personal savings in the English-speaking countries and other industrial nations is a statistical illusion. It reflects markedly different patterns of company finance. When allowance is made for these institutional differences, the savings gap between the main industrial nations narrows significantly.

American and British companies have traditionally relied heavily on equity finance from shareholders and tried to avoid using banks for long-term funds. Trading profits have three outlets. They can be paid to banks to cover interest, distributed to shareholders as dividends, or retained in the business. In Britain today, retentions are much larger than either interest payments or dividends. In 1987 they amounted to almost £46 billion, out of total trading profits by industrial and commercial companies of £69 billion.

There is a temptation to say that, because funds have been retained, they "belong to companies" and not to shareholders. This line of thought is a hallucination. Properly considered, companies are legal fictions. They have no autonomous personality and exist to serve the interests of their shareholders. Companies do not belong to themselves, but to people.

Retained profits are devoted mostly to investment in plant, equipment and buildings, and are therefore part of a nation's savings. It would be reasonable, in a logically organized set of national accounts, to allocate the £46 billion of corporate retentions to personal savings. However, the statistical convention is to attribute retentions to the impalpable "company sector" and not to the undoubtedly real "personal sector". Since £46 billion is equivalent to more than 10 per cent of gross national product, its reclassification to persons would add more than 10 per cent to the savings ratio.

As a result, that ratio would jump to about 16 per cent in Britain. A similar adjustment would also be needed in the US where, again, corporate retentions are extremely large as a share of national product. The American savings ratio would become about 15 per cent. These numbers look much closer to the international averages.

But there is the obvious counter-argument that retentions could also be re-classified in Japan and Europe. If it had the same effect as in the US and Britain, the savings gap between the English-speaking nations and other industrial countries would be unaffected.

But here we come to the key point. Because of the very different way companies finance themselves in Japan and Europe, corporate retentions are much lower as a share of profits and national product than in the US and Britain. In Japan and Europe companies have tended to have a small base of equity capital and bank finance has been the principal source of long-term capital. A higher proportion of trading profits is therefore needed to pay interest on bank debt, while the banks dominate the provision of funds for investment. Since bank deposits are held by persons, the indirect result of the system is that much more of company profits and investment ends up being categorized with the personal sector than in the English-speaking world.

These are just statistical tricks. The Europeans and the Japanese require their companies to pay out bank interest which comes into the hands of "persons", who then leave the money with the banks, who then lend it out for industrial investment; the Americans and British expect companies to keep the bulk of profits in their own hands, where the funds are treated as "retentions", which again become available to finance industrial investment. The essence of the matter is the same in both cases. It is only labels and definitions which are different.

The misfortune of the English-speaking nations is that their way of structuring company finances makes their "personal sectors" appear spendthrift and improvident, and encourages all sorts of silly remarks about their general inadequacy compared to the Japanese and the Germans.

The underlying realities of business and finance are remarkably similar all over the world. Although there is much wrong with the American and British economies, and even perhaps with Anglo-Saxon patterns of corporate finance, Mrs Thatcher and Mr Bush should not feel any particular inferiority complex about their nations' low personal savings ratios.

Tuesday, November 22, 1988

THE TIMES

## Commentary • TIM CONGDON

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Tuesday, November 22, 1988

chex.md/mw/130 **UNCLASSIFIED**

FROM: MISS M P WALLACE
DATE: 23 November 1988

**MR PATTERSON - DNS**

cc PS/Economic Secretary
Miss O'Mara
Mr Rich

Mr Wilson
Mr Hickman Robertson
Mr Watts NSB
Mrs Cullum

**CAPITAL BOND CERTIFICATES**

The Chancellor was most grateful for your minute of 21 November, which attached an example of the new Capital Bond "Investment Certificate". He is entirely content with the design.

**MOIRA WALLACE**

chex.ps/aa/22 CONFIDENTIAL

FROM: A C S ALLAN
DATE: 23 November 1988

MR HIBBERD

cc Sir P Middleton
Sir T Burns
Mr Peretz (*)
Mr Sedgwick
Mr Gieve (*)
Mr O'Donnell
Mr Pickford (*)
Mr Bush (*)
Mrs Chaplin (*)
(* with copy of Sir T Burns' note)

**NATIONAL INSTITUTE ECONOMIC REVIEW**

The Chancellor was grateful for your minute of 22 November.

2. On monetary versus fiscal action, apart from the basic point that - as we have always said - monetary policy is the answer to inflation, he thinks it would also be worth using the line which Sir T Burns took at the recent OECD EPC meeting (see his note to the Chancellor of 17 November).

3. The Chancellor would be grateful for a note on the point in your paragraph 20(ii) that £9½ billion of fixed rate non-Government sterling issues have been made so far this year, for use in the Debate on the Address and/or the TCSC. It would be helpful to have this by the end of the week.

ACSA

A C S ALLAN

FROM: MISS M O'MARA
DATE: 25 November 1988

ECONOMIC SECRETARY

cc: Chancellor
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Peretz
Mr Gieve
Mr Grice
Mrs Davies
Mr Rich
Ms Ryding
Mrs Chaplin
Mr Patterson - DNS

[This will keep the disgruntled correspondence flowing in - MPW]

**NATIONAL SAVINGS INTEREST RATES**

Today's 1 per cent rise in interest rates raises the question of whether we should make an early move to increase National Savings variable rates too. This submission recommends that we postpone any decision until we have a better idea of how competing retail rates will settle down and until we are ready to announce a decision on the interest rate for the new Capital Bond.

Background

2. We last announced an increase in National Savings variable rates on 26 August, following the previous 1 per cent rise in base rates. They currently stand at:

| | |
|---|---|
| Income Bond | 11.2 per cent true rate (effective from 9/10) (10¾ per cent paid monthly) |
| Deposit Bonds | 10¾ per cent (effective from 9/10) |
| Investment Account | 10 per cent (effective from 9/9) |

3. For basic rate taxpayers, these rates are already below the competition. Inflows have tailed off since August, partly for this reason and partly because we were deliberately slow to raise rates on National Savings gross products earlier in the summer, while short-term rates elsewhere were rising steadily. New investment in Income Bonds is now running at around £140 million a month, compared with £220 million at the beginning of the financial year, while repayments have increased sharply, and new money is now coming into the Investment Account at a rate of only

£120 million a month, compared with £170 million in April. Deposit Bonds have, of course, been withdrawn from sale (although we shall still need to set a rate from time to time for the existing stock).

Assessment

4. Although it now looks as though the gross products will make a lower contribution to funding than we thought earlier in the year, this is not a matter for concern. Income Bonds and INVAC money can be withdrawn at quite short notice, and funds on the GER can be withdrawn in about 8 days, so none of these products represents good quality funding. Nevertheless, we need to watch movements in competing rates and take care that National Savings rates do not fall so far out of line with those prevailing elsewhere in the economy that the Government becomes exposed to charges of bad faith.

5. Moreover, we need to bear in mind the launch of the Capital Bond at the beginning of January. We shall need to decide the interest rate shortly before Christmas and shall be putting a submission to you nearer the time. We think we should consider the various interest rate decision together: we shall want to do all we can to make the Capital Bond look attractive, not only in relation to external competition but also in relation to other, more liquid, DNS products.

Conclusion

6. We recommend that we wait to see how bank and building society deposit rates respond to today's rise before taking any decision on National Savings. A natural opportunity to announce a change in variable rates would arise when we set the return on the Capital Bond in 3-4 weeks' time.

7. The thrust of this submission has been agreed with DNS.

8. Would you be content to proceed in this way?

MOM

MISS M O'MARA

mg2.cc/Sheath/91g5.25.11

CC APH

**FROM:** R L SHEATH
**DATE:** 25 November 1988

1. MR GRICE JWG 25.11.88
2. CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz
Mr Sedgwick
Mr O'Donnell
Miss O'Mara
Mr Pickford
Mr Bush
Ms Ryding
Mrs Chaplin

MAMC: K6

**STERLING BOND ISSUES**

Your response to Mr Hibberd's submission of 22 November on the National Institute Economic Review asked for a note on the £9½ billion of fixed rate issues made in the sterling market this year other than by government.

2. The attached table is based on data collated by the Bank of England. The total is ticking along all the time and by 23 November had reached £9.9 billion. You should be aware, however that £729 million of the domestic issues and £316 million of the external money has been preference shares. Thus the non-preference share total is £8.8 billion.

3. The statistics show that £6.6 billion of the total is from UK issuers and £3.3 billion overseas. But no reliance can be placed on this breakdown. Many, if not most, of the issues are attached to swap deals whereby the nominal issuer hands over the fixed rate proceeds to some other borrower in return for floating rate money. Without data on the swaps, it is not clear, therefore, who are the ultimate borrowers. We are discussing with the Bank and DTI statisticians how best to remedy this gap in the statistics.

4. On top of the fixed rate issues, a further £5.7 billion of floating rate notes have been issued in the sterling markets.

R L SHEATH

**NON GOVERNMENT STERLING FIXED AND FLOATING RATE ISSUES: 1988, TO 23 NOVEMBER**

| | £ million |
|---|---|
| **FIXED** | |
| Domestic Issues | 2585 |
| Bulldog Issues | 100 |
| Euro-sterling: | |
| Commercial UK | 2511 |
| Financial UK | 1485 |
| Commercial non-UK | 730 |
| Financial non-UK | 1410 |
| Overseas government & international organisations | 1070 |
| **TOTAL** | **9891** |
| (of which UK issuers) | (6581) |
| **TOTAL FLOATING RATE NOTES** | **5680** |

pvp

FROM: J S HIBBERD
DATE: 25 NOVEMBER 1988

CHANCELLOR

cc: Sir T Burns
Mr Odling-Smee
Mr S Davies
Mr Owen
Mr Darlington

**TIM CONGDON ON THE SAVINGS RATIO**

Moira Wallace's minute of 22 November asked for comments on Tim Congdon's piece in Tuesday's Times.

2. There is some substance in Congdon's point that companies' retained profits (used to finance investment) could conceptually score as personal savings, since the personal sector owns the companies (either directly or through life assurance and pension funds). With a different tradition of financing company sector spending (say by bank borrowing as in Japan and Europe) the bulk of these retained profits could well be distributed to the owners.

3. The implication of aggregating personal and company sector saving (to total private sector saving) is shown in Chart 1. It includes projections for 1988 and 1989 consistent with the Autumn Statement. As a share of GDP, total private sector saving was roughly stable over 1981-87, with rising company sector saving broadly offsetting the sharp fall in personal sector saving. (Interpretation of the figures has of course to be qualified in view of the residual error in the national account which might imply that saving is less than actually recorded).

4. This seems to be the basis for Congdon's assertion that the current low level of personal saving is not necessarily a cause for concern. However, total private sector saving will have been boosted over the last five years by the transfer of many public corporations into private ownership. Without this transfer private sector saving would have fallen more sharply than the Chart reveals. More generally the increased share of the private sector in housing and other aspects of the economy requires increased private sector investment and saving.

5. Chart 2 shows total private saving relative to total private investment, including forecasts for 1988 and 1989. Again the figures have to be interpreted cautiously given the residual error in national accounts. This is consistent with higher company sector spending and/or lower private savings. The investment numbers also take no account of stockbuilding, so the gap between savings and investment is relatively lower than it appears.

6. The key feature to note from the chart is that investment has risen steeply relative to savings since 1982. So much so that in 1988 the result has been a large current account deficit, in spite of a public sector surplus. If high investment is to be sustained into the medium term to support steady economic growth, savings would need to increase to avoid protracted current account deficits. The increase in domestic savings will probably have to come very largely from the personal sector. Congdon's view about the present level of saving thus seems too sanguine.

J S HIBBERD

pf.dc.47

FROM M C SCHOLAR
DATE 29 NOVEMBER 1988

MR HUDSON

cc Sir Peter Middleton
Sir Terence Burns
Mr Peretz
Mr Sedgwick
Mr O'Donnell
Miss O'Mara
Mr Pickford
Mr Grice
Mr Bush
Ms Ryding
Mr Sheath
Mrs Chaplin

**STERLING BOND ISSUES**

I attach a revised version of your text.

MCS

C.

**M C SCHOLAR**

We spoke, & agreed this was more for TCSC than Debate. See also Judith's comment, below.

AH

**STERLING BOND ISSUES**

The transformation of the government's own finances is good news, too, for companies planning to raise long term finance for investment. After years of taking the lion's share of the long term savings market the government is now repaying rather than issuing new debt. In doing so it is leaving room for companies who wish to finance their activities by issuing debt; and although short-term interest rates have risen sharply over the past five months, long-term rates have barely moved.

There are signs that companies are taking advantage of the opportunity this presents: some £10 billion has been raised through fixed-rate issues in the domestic and Eurosterling markets so far this year, by the private sector and overseas borrowers.

UNCLASSIFIED

FROM: JUDITH CHAPLIN
DATE: 29 November 1988

MR HUDSON

## STERLING BOND ISSUES

You asked for comments on your paragraphs. Anything that argues against the adverse effects on investment of the rise in short-term interest rates is useful. However is this fact a bit esoteric on its own, particularly the last paragraph. Would it not be better in the context of the general increase in the liquidity of British companies (the fact that ICC's borrowings were over twice their bank deposits in 1980, whereas they now exceed them only by a sum of 45% - although obviously not using this figure which still shows substantial borrowings) and the shift from financing from banks to financing from equity.

JC

JUDITH CHAPLIN

Mr Darlington cc Mr Sedgwick

Did these figures come from your notes on company finances?

AH

chex.md/ah/72 UNCLASSIFIED

FROM: A P HUDSON
DATE: 29 November 1988

**MR SCHOLAR**

cc Sir P Middleton
Sir T Burns
Mr Peretz
Mr Sedgwick
Mr Odling-Smee
Mr O'Donnell
Miss O'Mara
Mr Pickford
Mr Grice
Mr Bush
Mrs Ryding
Mr Sheath
Mrs Chaplin

**STERLING BOND ISSUES**

The Chancellor was grateful for Mr Sheath's 25 November minute.

... 2. I attach a shot at some text, which could be used in the Debate this afternoon, or at the TCSC tomorrow. The Chancellor would be grateful if you and copy recipients could cast an eye over it. In case we do need it for today, please could I have comments by 12 noon, with apologies for the short notice.

A P HUDSON

**STERLING BOND ISSUES**

Companies wishing to borrow by issuing long-term debt are now very well placed to do so. The Government is now repaying debt, on a substantial scale, and no longer making large issues of its own. And although short-term interest rates have risen sharply over the past five months, long-term rates have barely moved [figures].

There are signs that companies are taking advantage of the opportunity this presents: Some £10 billion has been raised through fixed-rate issues in the sterling market so far this year, by the private sector and overseas borrowers. This is [far] more than in previous years.

Because many of the issues are followed by swaps, we cannot say for certain how much of the funds have been raised by UK companies. But the amount is likely to be substantial.

dti
the department for Enterprise

The Hon. Francis Maude MP
Parliamentary Under Secretary of State for
Corporate Affairs

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

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ACTION FST
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BF 21/12 15/12

Department of Trade and Industry

1-19 Victoria Street
London SW1H 0ET

Switchboard
01-215 7877

Telex 8811074/5 DTHQ G
Fax 01-222 2629

Direct line 215 4417
Our ref
Your ref
Date 2 December 1988

Dear Chancellor,

COMPETITION INITIATIVE ACTION PROGRAMME

The next meeting of E(CP) has now been fixed for 19 January and will consider proposals for the future work of the Committee based on a revised Competition Initiative Action Programme. It is important that we ensure that the Programme includes all those measures which we are taking or proposing to take to promote and increase competition in the economy (although privatisation per se is outside the scope of the initiative). I should be grateful, therefore if you and other colleagues to whom I am copying this letter would consider what new items you would wish to see entered in the Programme, and what amendments should be made to the current version which I circulated in July (copy attached for ease of reference).

As far as possible, new topics should be accompanied by firm timescales (or, where this is impracticable, sensible interim report-back dates). Objectives which have been achieved will need to be deleted (and it would be helpful here if colleagues could note precise details and dates of legislation, agreements, Directives etc) and current items may need updating to reflect recent developments.

To enable the revised programme to be drawn up and circulated in advance of the meeting on 19 January, and taking account of the Christmas break, I should be grateful if I could have responses by 16 December.

I should also remind colleagues that reports are due in either December or January next year on a large number of topics in the current programme. Lead Departments are listed next to the relevant item. A note on what progress has been made and what remains to be done on each will be sufficient for this purpose.

dti

the department for Enterprise



I see no need to provide these by 16 December but it would obviously be useful to circulate the reports before the January meeting in case anything emerges which the Sub-Committee might wish to discuss.

I am copying this letter and attachment to Geoffrey Howe, James McKay, Douglas Hurd, Malcolm Rifkind, Peter Walker, Tom King, members of E(CP) and Sir Robin Butler.

Yours sincerely

Chris Nerll

pp FRANCIS MAUDE

(approved by the Minister and signed in his absence)

CVGAII

the enterprise initiative

## COMPETITION INITIATIVE: ACTION PROGRAMME

| Action | Timing | Lead Department |
|---|---|---|
| **Housing** | | |
| Measures to improve private and public rented housing market: further extension of right to buy provisions; development of assured tenancies and shorthold lettings; introduction of right for local authority tenants to transfer to other landlords; powers to set up Housing Action Trusts to take over local authority housing. | Legislation to be passed by end 1988 | DoE |
| In Scotland, create a new agency, Scottish Homes, to promote the emergence of new landlords. | Legislation to be passed by end 1988 | Scottish Office |
| Introduce rules for authorisation of institutions to offer conveyancing | Early 1989 Consultation Paper to issue late 1988 | LCD |
| **Financial Services** | | |
| Ensure any EFT/POS system allows free access (subject to security etc considerations) and anti-competitive effects examined. | continuing - report to E(CP) October 1988 | Tsy/DTI |
| **Transport** | | |
| Secure abolition of restrictions in EC coastal shipping trades | 1992 - report to E(CP) December 1988 | DTp |
| Broaden private sector participation in provision of ancillary railway services | continuing - report to E(CP) October 1988 | DTp |
| Restructure London Buses Limited into smaller competitive companies | April 1989 | DTp |
| Extend bus deregulation to London | Early 1990's - report to E(CP) December 1988 | DTp |
| Agree liberalisation of road haulage within EC | 1992 - report to E(CP) December 1988 | DTp |
| Extend competition in international coach operation | Member States considering final Commission proposals - report to E(CP) October 1988 | DTp |
| Consult on liberalisation of taxi and hire car legislation | Consultation period ends August 1988 | DTp |

| Action | Timing | Lead Department |
|---|---|---|
| Secure further liberalisation of air services within the EC | June 1990 - report to E(CP) December 1988 | DTp |
| **Professions** | | |
| Examine barriers to multi-disciplinary practices in the professions | Paper to E(CP) October 1988 | DTI |
| End patent agents' statutory monopoly and prohibition of mixed practices | Legislation by end of 1988 | DTI |
| Pursue changes to advertising rules of Chartered Institute of Patent Agents and European Patents Institute and relaxation of EPI monopoly | continuing - report to E(CP) December 1988 | DTI/OFT |
| Monitor construction industry profession's rules on fee scales | continuing - report to E(CP) October 1988 | DTI/OFT |
| Advertising restrictions of osteopaths, consulting engineers and doctors referred to MMC: subject to conclusions consider further relaxation | 1989 (MMC reports due November 1988 (2) and February 1989) | OFT/DTI |
| Consider scope for introduction of greater competition in health care services | April 1990 - report to E(CP) January 1989 | DHSS |
| Examine the extent to which restrictive practices in legal profession affect efficient administration of justice | Paper to E(CP) October 1988 | LCD |
| Consider ending ban on solicitors in Scotland sharing fees with non-solicitors so as to allow multi-disciplinary practices | Paper to E(CP) October 1988 | Scottish Office |
| **Labour Market** | | |
| Consider further action against restrictive labour practices and local authority national collective agreements | Progress report to E(CP) July 1988 | D Emp/DoE |
| **Labour Market continued** | | |
| Review coverage of Wages Councils | Report submitted to D.Emp Ministers January 1988 - report to E(CP) October 1988 | D Emp |
| **International Trade** | | |
| Programme of economic assessments of VRAs and decisions on future widened to include all restrictions on the import of non-agricultural goods | Papers to E(CP) July 1988 (follow-up to 3 May E(CP) meeting) and October 1988 | DTI |

| Action | Timing | Lead Department |
|---|---|---|
| Continue liberalisation of trade in goods and services in new GATT round launched 1986. Consider direction of round after Mid-Term Meeting in December 1988 | By end 1990 - report to E(CP) January 1989 | DTI |
| Review results of monitoring exercise on banana prices/margins | 1990 | MAFF/DTI/FCO |
| Remove tariff barriers on trade in visual and auditory materials between EC and USA | continuing - report to E(CP) December 1988 | DTI |
| Establishment of Open Systems Interconnection standards for IT equipment | End Government involvement by 1992 report to E(CP) January 1989 | DTI |
| **Domestic Market** | | |
| Review shop opening hours with a view to possible legislation | 1988/89 - report to E(CP) March 1989 | HO |
| Broadcasting White Paper to include proposals on: competitive tendering for TV contracts; possible reconstitution of Channel 4; implementation of 25% independent programme production target; subscription TV; new TV services; networking arrangements, and new broadcast data services. | 1988/89 | HO |
| To be followed by legislation | 1989/90 - report to E(CP) January 1989 | HO |
| Legislation to deregulate non-BBC radio broadcasting | 1989/90 - report to E(CP) January 1989 | HO |
| Increase competition in hospital services | continuing (subsumed by NHS Review) - report to E(CP) March 1989 | DHSS |
| Review arrangements for letting NHS pharmacy contracts to ensure competition not inhibited | Review started April 1988 - to report October 1988 | DHSS |
| New law on unregistered design to allow independent parts manufacturers to compete whilst safeguarding rights of originators | Legislation by end of 1988 | DTI |
| **Domestic Market continued** | | |
| Develop plans for direct auction of radio spectrum bands | Paper to E(CP) July 1988 | DTI |

| Action | Timing | Lead Department |
|---|---|---|
| **Telecommunications** | | |
| Limited liberalisation of specialised satellite services | Six new licences to be issued by end 1988 | DTI/Oftel |
| Review prohibition on resale of leased lines | 1989 - report to E(CP) March 1989 | DTI/Oftel |
| Review BT/Mercury duopoly | 1990 | DTI |
| **Agriculture** | | |
| Monitor relationship between Dairy Crest and Milk Marketing Board following Touche Ross Report | Review 1988. Paper to E(CP) July 1988 | MAFF |
| Review potato market support arrangements | By 1989. Paper to E(CP) July 1988 | MAFF |
| NCC study of CAP commissioned 1986 Consider conclusions | By September 1988 | MAFF |
| Review the role of the British Wool Marketing Board and its subsidiaries | Paper to E(CP) July 1988 | MAFF |
| Transfer tuberculin production from Central Veterinary Laboratory to pharmaceutical industry | 1988/89 | MAFF |
| Transfer funding of "Food From Britain" to industry | 1991/2 - report to E(CP) March 1989 | MAFF |
| **Education** | | |
| Measures to increase parental choice of school and representation on schools' governing bodies (including, in Scotland, the introduction of School Boards); legislate to enable schools to apply for grant-maintained status. | Legislation 1988 | DES/Scottish Of[illegible] |
| Establish City Technology colleges | continuing - report to E(CP) December 1988 | DES |
| Improve quality of work-related non-advanced further education (with MSC) | continuing - report to E(CP) January 1989 | DES |
| **Public Procurement** | | |
| Examine scope for private sector provision or management of establishments, escorts and court-manning for remand prisoners | 1988 - report to E(CP) December 1988 | HO |

| Action | Timing | Lead Department |
| --- | --- | --- |
| Extend opportunities for private sector to install and maintain police and fire services telecommunications equipment and widen options for procurement of equipment | 1989 - report to E(CP) March 1989 | HO |
| Increase competition in drugs procurement including measures to improve GPs' prescribing practices, allowing for parallel imports in discount recovery scheme and study of the generic market. | continuing. Study of generic market now under way - report to E(CP) December 1988 | DHSS |
| Continue to encourage own-period tendering, design and build, and fee competition in highway works programme as well as other changes in procurement procedures designed to sharpen up competition | continuing - report to E(CP) December 1988 | DTp |
| MSC to extend use of competitive tendering for providers of adult training | continuing - report to E(CP) March 1989 | D Emp |
| Continue to encourage large organisations, including Government Departments, to consider the needs and potential of small suppliers in their procurement policies | Review March 1989 | D Emp |
| Extend compulsory competitive tendering and separate accounting by local authorities to a range of services (including refuse collection, street cleansing, building cleaning, vehicle maintenance, catering, including school meals, and ground maintenance. Sport and leisure management to be added later by order). | Measures incorporated in Part I of Local Government Act 1988. Provisions will begin to apply in respect of work carried out from 1 August 1989 | DoE |
| Provide Departments with choice between using PSA or outside agents for services formerly carried out by PSA alone. | April 1990 - report to E(CP) March 1989 | DoE (PSA) |
| Extend competitive tendering and contracting out in defence support services | continuing - report to E(CP) January 1989 | MoD |
| Increase range of defence contracting firms by Small Firms Initiative and open tendering procedures | continuing - report to E(CP) January 1989 | MoD |
| Increase proportion of contracts placed by competitive procedures | continuing - report to E(CP) January 1989 | MoD |
| Review operation of Pharmaceutical Price Regulation Scheme | Start Sept 1988 - report to E(CP) March 1989 | DHSS |

ANNEX B

## ACHIEVEMENTS SINCE PREVIOUS PROGRAMME (21.1.88)

Restrictions on dentists', chiropodists' and physiotherapists' advertising rules relaxed following negotiations with the Director General of Fair Trading.

The Social Security Act 1986 set the framework for financial institutions to move into the personal pensions market. The scheme took effect from 1.7.88.

The Employment Act received Royal Assent in May. It removes the legal basis for post-entry closed shops and gives employers the means to resist industrial action to establish or maintain closed shop practice.

The Licensing Act also received Royal Assent in May reforming liquor licensing hours.

Part II of the Local Government Act 1988 received Royal Assent in March. Provisions outlawing non-commercial conditions in local authority contracts and tender invitations came into effect in April 1988.

From April 1988, Departments have been free to use outside agents to design and manage projects for them. For all major new works projects of over £1 million or more in construction costs, three firms are invited to prepare competitive bids.

OTHER DELETIONS

| | | |
|---|---|---|
| Introduce trial scheme for tendering for fees be local Veterinary Inspectors | 1988 | MAFF |

mg.ee/dlcp/2.12-est

CONFIDENTIAL

From : D L C Peretz
Date : 2 December 1988

ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Miss O'Mara
Mr Gieve
Mr Grice
Mrs M Davies
Mr Rich
Mrs Ryding
Mrs Chaplin

Mr Patterson - DNS

**NATIONAL SAVINGS INTEREST RATES**

At Wednesday's Funding Meeting we agreed to let you have a further note (following up Miss O'Mara's note of 25 November) about the possibility of an early move in national savings variable interest rates.

2. We agreed that no change was needed for the time being in the fixed interest certificate or index-linked certificate, or in the general extension rate on matured certificates. But we took a provisional decision to make an early announcement of new rates for income bond (and deposit bond), and the investment account - which take 6 weeks and 2 weeks respectively after announcement to come into effect.

3. The other part of the picture is that we have to decide before Christmas on the rate for the new capital bond - though this will not be announced until the DNS press conference on 3 January, the day before its launch.

**Relevant Factors**

4. Normally we set rates on these variable rate products in terms of their relationship with competing retail deposit rates. The strategy since the beginning of this financial year has been to try to set the rates just a little bit below the

competition, so far as the taxpaying investor is concerned - though at rates, of course, which for the non-taxpayer remain unbeatable. We have been trying to strike a balance between on the one hand maintaining confidence in national savings and good faith with investors; and on the other not attracting huge net inflows into what are very liquid forms of deposit at a time when the Government has no net borrowing need at all, so as to leave room within the funding arithmetic to sell better quality products.

5. Although we moved rates on these products very quickly after the end-August base rate rise, this was partly to catch up with rises in competing retail rates that had already occurred following previous base rate moves. The more normal course is to wait after a base rate rise to see how the building societies and banks move their retail interest rates. Nevertheless, as we agreed there is a good case on this occasion for moving in advance of the societies, particularly if we think we want only a fairly modest move.

6. The second relevant consideration on this occasion is the relationship with the rate of interest to be set on the new capital bond, to be launched in January. Although a decision is not needed for another 2-3 weeks, for the reasons explained below we think we need to take a provisional decision on that before announcing a new rate for income bonds and investment account.

**Competing Rates**

7. For the taxpayer, the rates on income bond and investment account are already perhaps a little lower in relation to competing rates than we would ideally want; certainly net inflows recently have been poor, and we are now experiencing some net outflows. The following table illustrates the present competitive position so far as a 25% rate taxpayer is concerned.

Return after tax to 25% rate taxpayer

| | | |
|---|---|---|
| Income bond | 8.4% | (a true gross return of 11.2%, expressed as 10¾%) |
| Investment account | 7.5% | (expressed as 10% gross) |
| Average bank instant access rate | 8.0% | |
| Average building society instant access rate | 8.4% | |
| Average 90 day building society deposit | 9.0% | |

8. Our best guess is that building society mortgage rates will rise ¾% in January, with building society (and bank) deposit rates rising by at least ½% - equivalent roughly to a ¾% rise in DNS gross rates. Given that we start from a slightly unsatisfactory position, ¾% looks the lowest increase in national savings rates we could contemplate. There would be a case for considering 1%. Either way, we would want to maintain the current differential between income bond and investment account rates, which in part reflects the difference in liquidity between the two products, and in part the higher administrative costs for investment account. Although the deposit bond is no longer on sale we need to set rates for existing holders, and we suggest we set this rate in future at the same level as the income bond rate (as it is at present).

9. The choice is thus between raising the quoted rate for income and deposit bonds from the current figure of 10¾% to either 11½% or 11¾%; and for the investment account from the current 10% to 10¾% or 11%.

**Capital Bond**

10. We need to consider the rate we are going to set on capital bond before we set a new income bond rate, since DNS strongly

believe that as a marketing point it is essential for the capital bond return - at least initially - to be set no lower than the publicly quoted interest rate for income bonds. So if the income bond rate is set at 11½%, DNS think the return on the capital bond needs to be at least 11½% - and if it were set at 11¾% the capital bond would need again to be set at least at that level.

11. This causes difficulties because of the shape of the yield curve. Although in principle you might think it possible to market a lower rate for the capital bond on the basis that the return is guaranteed for five years, in marketing terms it would be very difficult. On the other hand five year market rates are considerably below 1 month and 1 year rates. The capital bond represents five year money, and as such the starting point for setting its interest rate must be the relationship with the rate we would have to pay on a new issue of five year gilts, if we were to have one. At present this would be a little over 10¾%. Since there is an extra administration cost with national savings, equivalent to roughly ¼%, this would suggest setting the interest rate on the capital bond at not much more than 10½%.

12. There are however other factors to be taken into account :-

i) drawing on the experience with savings certificates, we can expect some modest early encashment of capital bonds. Because we will have a very steep rake for the interest rate - with no interest payable at all on encashments within the first year, and the bulk of the interest payable only after the fourth and fifth years - early encashments in fact reduce the average cost of the money. It is hard to know what proportion of early encashments there will be, but drawing on experience with savings certificates this effect might be such as to be worth around ½% in terms of the quoted interest rate.

ii) there is of course the extra argument for selling capital bonds, rather than short gilts - we are trying to raise the totality of firmly held personal savings.

It may be worth paying a little more for this, although if we raise the rate too far most of the effect may be to bring about switching of savings from elsewhere, rather than an increase in the total.

iii) there is a case for making the initial return fairly generous, to get the product established - perhaps best regarded as part of its launching cost.

13. A combination of these arguments could justify a return for the launching issue of capital bonds of 11½%, but probably no more, assuming gilt yields remain around their current level.

14. There may be some advantage, and we are discussing this with DNS, in presenting the initial issue as especially generous, and perhaps in some way as time limited, with ½% of the total return expressed in the form of a special bonus rate of interest on the final year of holding. Special limited launching offers of this kind are quite common in the private sector. The idea that the issue might be time limited could actually help to boost initial sales. We are considering the possibilities further with DNS, and will put forward firmer proposals when it comes to making a final decision on the rate.

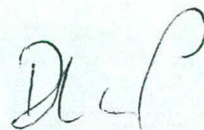
**Summary and Conclusion**

15. In short, we are for the time being constrained on how far we can raise the interest rate on income bonds by the rate we expect to set on the capital bond. It is hard to see at present that a rate on the latter of more than 11½% would be justified, and that would imply a maximum increase in the income bond rate of ¾%, to 11½%. That in turn is I think also the minimum we could contemplate for the income bond - and since it may not be seen as very generous (depending on what the building societies eventually do) there is an argument for announcing it quickly, ahead of the building societies. (This argument would have less force of course if we were prepared to pay a higher rate on the capital bond).

16. So that is what we recommend : an early announcement of a rise in the income bond (and deposit bond) quoted rate to 11½%, and in the investment account rate to 10¾%. This implies a provisional decision to set the capital bond rate at 11½%, but we

will put forward a fuller submission on this nearer the time when a final decision has to be taken.

17. John Patterson supports these conclusions.



D L C PERETZ