PO-CH/NL/0193 PART B

Chex
Lawson

PART B

SECRET

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PO -CH /NL/0193

PART B

Begins: 7/4/88

Ends: 11/11/88

DD: 25 years

7/9/95

CHANCELLOR'S 1988 PAPERS
ON FUNDING AND GILTS

PO -CH /NL/0193
PART B

CONFIDENTIAL

bf 11/4

FROM: J M G TAYLOR
DATE: 7 April 1988

bf 15/4

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mr Scholar
Mrs Lomax
Miss Peirson
Mr Peretz
Mr Culpin
Miss Sinclair
Mr Ilett
Miss O'Mara
Mr McIntyre
Mr Cropper
Mr Tyrie
Mr P Lewis - IR
Mr Jenkins - T.Sol.

NICs ON GILTS ETC.

The Chancellor has seen Mr McIntyre's note of 30 March, and the enclosed paper.

2. The Chancellor hopes we can reach early agreement on this, and awaits the Financial Secretary's recommendations. He has asked whether there is a yield estimate from these possible changes, and, if so, what it is.

JT

J M G TAYLOR

SECRET

From : D L C Peretz
Date : 11 April 1988

ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Sir G Littler
Mr Scholar
Miss O'Mara
Mrs Ryding
Mr Cropper

Would it? Why?
N.

PS. Pse let me know final 1987-88 underfunding outturn ASAP.
N.

IG TRANCHETTES

Although the long end of the gilt market fell following Friday's base rate cuts, the short end rallied, and the market as a whole is reasonably good today. Index-linked stock have done particularly well, especially longer IGs - which rose a point on Friday, and have risen a further ¼ point this morning.

2. The Bank sold on Friday around £100 million of the 1992 IG, and sold out their remaining holdings of longer IGs (a further £20 million or so). They are left with £110 million of 1992 IG on their books, and would like to replenish their portfolio of longer IGs in case there is further demand.

3. Specifically, they would like to announce this afternoon :-

i) £100 million of IL Treasury 2½% 2011 and

ii) £100 million of IL Treasury 2½% 2020.

4. If they sell these stock, and the remaining £100 million or so of 1992 IG this month, it would bring the month's total funding to £1 billion. The Bank accept that this would need to be offset either this month - or later - by buying in longer conventional stock when the price is right (long yields are currently around ¼% below the $9^1/_8$% floor we set for buying in operations this month).

5. Our objective remains (at current yields) to sell as many IGs as we can, offsetting the sales by buying in long conventionals, as necessary, within the funding arithmetic. I therefore recommend we agree to this proposal.

DLCP

D L C PERETZ

From : D L C Peretz
Date : 11 April 1988

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir G Littler
Mr Scholar
Miss O'Mara
Mrs Ryding
Mr Cropper

Thanks. Noted. Important presentationally that, if X & Y are correct, we have already fully funded 1987-88. Presentation. NL

GILTS/FUNDING POSITION

You asked why selling more IGs would probably mean we have to buy in conventional stock sometime during the year (paragraph 4 of my minute of earlier today). You also asked for an up to date figure for the 1987-88 funding outturn.

2. The Bank in the end did not bring the planned IG tranchettes this afternoon because the IG market fell away quite sharply after lunch : they will wait for a better day.

<u>1988-89 Funding position</u>

3. Because of the negative PSBR, we will need to sell very few gilts this year; quite possibly we will need <u>gross</u> sales of only around £3bn, although there are plenty of unknowns (including the PSBR and the sign and scale of net intervention over the year). X We have already sold £700m of gilts in April : and we are to have two further auctions of up to £1bn each. Looked at like that, on current figuring, auctions apart there would be little more funding to do over the rest of the year.

minutes now here (we had not seen before) X

4. But we agreed at the Economic Secretary's Funding Meeting before Easter that we should take advantage of this position to achieve some <u>restructuring</u> of outstanding debt, to reduce expected servicing costs. Hence my comment that any additional sales of IGs now are welcome but are likely to have to be matched sooner or later during the year with some buying in of conventionals. At current yields this is precisely what we want : on MTFS projections replacing long conventionals with IGs would save us a good deal of money.

1987-88 Funding outturn

5. We will have a better idea of the outturn when we have the first estimate of the March PSBR figure, this Wednesday. Before that, the "first guess" money figures, which we should get tomorrow afternoon, may give us a very preliminary estimate of the year's outturn. For a more final estimate we will have to wait for the full PSBR figures (published on 20 April) and the March banking figures (published on 21 April). As of today, our best guess remains roughly as set out for the pre-Easter Funding Meeting : an underfund of approximately £½ billion.

6. This is after taking account of the £300m underfund carried over from 1986-87. The funding estimate for 1988-89 given in paragraph 3 above assumes a £½ billion carry over from 1987-88.

DLCP

D L C PERETZ

ps2/17M

SECRET

MP

FROM: MISS M P WALLACE
DATE: 12 April 1988

MR PERETZ

cc PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr Scholar
Miss O'Mara
Mrs Ryding
Mr Cropper

GILTS/FUNDING POSITION

The Chancellor was grateful for your minute of 11 April. He has noted that, if our best guess of an under-fund of approximately £½ billion in 1987-88 is correct, then the £700 million gilts we have sold in April mean we have already fully funded last year's intervention, which is presentationally important.

MPW.

MOIRA WALLACE

FINANCIAL SECRETARY TO THE TREASURY

FROM: J J HEYWOOD
DATE: 13 April 1988

PS/CHANCELLOR

cc PS/Chief Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Phillips
Mr Scholar
Mrs Lomax
Miss Peirson
Mr Peretz
Mr Culpin
Miss Sinclair
Mr Ilett
Mr MacAuslan
Miss O'Mara
Mr McIntyre
Mr Cropper
Mr Tyrie

Mr P Lewis - IR
Mr Jenkins - T.Sol

NICs ON GILTS ETC.

The Financial Secretary has now discussed Mr McIntyre's submission of 30 March with officials.

2. The Financial Secretary's view is that we should initially confine the NIC charge to gilts, other fixed interest securities and "derivatives" of these (such as options and futures). The Financial Secretary sees little point in extending the charge at this stage to other marketable securities such as equities, which are not being used as remuneration at present, as far as we know.

3. Officials fear that if equities are not included within the charge, the more sophisticated companies might immediately begin to remunerate their employees in this way. They argue that this might make the Government look naive, and would defeat the object of the exercise unless it were immediately stopped in what would look like a "second bite of the cherry".

4. The Financial Secretary's view, however, is that since there is no evidence that equities are currently being used, since there are non-negligible transactions costs involved in paying employees in equities, and since we can widen the scope of the NIC charge to include equities as soon as abuse appears, there is no case at present for going beyond fixed interest securities. The Financial Secretary does think, however, that we should issue a warning that we would not hesitate to widen the scope of the charge if further abuse appears.

5. One advantage of excluding equities is that we would not have to decide now whether or not to impose the NIC charge on unapproved share schemes. The Financial Secretary sees advantage in getting the S.79 reforms on to the statute book before contemplating a new charge on unapproved schemes.

6. On the other issues, the Financial Secretary believes that:-

(i) The DTI should be consulted about the use of the FSA for definitional purposes;

(ii) Both employer and employee NICs should be imposed;

(iii) DHSS Ministers should make the announcement as soon as possible (and preferably on 26 April so that the Financial Secretary can refer to it in his Second Reading Speech).

7. The Financial Secretary has asked officials to provide a draft letter to send to Mr Moore at the beginning of next week.

J.H.

JEREMY HEYWOOD
Private Secretary

Prg -

FROM: J P MCINTYRE
DATE: 15 April 1988

yes

FINANCIAL SECRETARY

TRD PS/FST
AD 18/4 -

cc Chancellor
Chief Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mr Scholar
Mrs Lomax
Miss Peirson
Mr Peretz
Mr Culpin
Miss Sinclair
Mr Ilett
Miss O'Mara
Mr Ramsden
Mr Cropper
Mr Tyrie
Mr P Lewis (IR)
Mr P Jenkins (T.Sol)

Ch.
Content for FST to write as proposed? (You will see from PS/FSTs note, immediately behind, that FST in fact wanted to go for just fixed interest securities. But it must be right to widen the scope as Mr McIntyre suggests – if not to widen it still further to equities – if we are to avoid companies simply switching their remuneration away from gilts to other securities).
AS 15/4

NICS ON GILTS ETC

I attach a draft letter for you to send to Mr Moore setting out the proposals which were agreed at your meeting on 12 April. These are, of course, subject to the Chancellor's views. I am letting you have the draft now in view of the need to get rapid DHSS agreement if there is to be an early announcement.

2. We have given the precise coverage of the measures some further thought since your meeting, and we think that it would be appropriate to go for debt instruments generally and not just fixed interest securities. This is because some of the obvious alternatives to gilts, to which employers might turn, are floating rate instruments such as Floating Rate Notes. Extending the measure to debt instruments generally would avoid having to distinguish in the DHSS regulations between fixed and floating rate instruments.

3. The draft letter assumes that you would like DHSS Ministers to make an announcement early in the week beginning 25 April, if

that is possible, so that you could refer to the decision in the Second Reading debate on the Finance Bill.

4. The draft also presses Mr Moore to agree that the decision should become effective on the day it is announced. This is not the way NIC changes are normally handled. But, as the draft argues, there is a strong case here for immediate implementation in order to avoid forestalling.

5. My soundings of DHSS officials suggest that it should be possible for the announcement to be made early in the week beginning 25 April and for the measure to take immediate effect, assuming Mr Moore goes along with the proposals. The regulations would be laid (and take effect) the following day.

6. On this last point, DHSS have some misgivings about continuing to exempt equities, and they will no doubt express these to Mr Moore. The draft letter to Mr Moore therefore underlines that the announcement should be accompanied by a warning that evidence of NIC avoidance by other means would lead to further measures.

JPM

J P MCINTYRE

DRAFT LETTER TO MR MOORE

NICS AND GILTS

Thank you for your letter of 24 March agreeing that we should take action to remove the NIC exemption on earnings paid in gilts and other securities. I have now considered the report which has been drawn up by our officials.

It seems to me that, on the question of coverage, there is no doubt that we need to go further than removing the exemption on gilts. Otherwise, the measure could all too easily be avoided by using other similar instruments. The most likely such means of avoidance are other debt instruments such as debentures, bonds, and local authority stock. I believe we should subject all these fixed and floating rate debt instruments (and the instruments which are derived from them, such as futures and options) to NICs.

I do not think we need extend NICs to equities, at least at this stage. There is no evidence that they are at present being used to avoid NICs. And I am concerned that, unless compelled to do so, we should not take action which might be seen as in conflict with our wider share ownership policy, particularly on employee shares. If, however, we were to find that equities were being widely used as an alternative to gilts for this purpose, we could then move against equities as well. Indeed, I would see some merit in making it clear, when the decision is announced, that we would not hesitate to extend NICs further if alternative instruments, such as equities or commodity contracts, were used.

Although the main target of this measure would be payments to people earning more than the UEL, it would be consistent to apply employees as well as employers NICs. In any event, I understand that primary legislation would be needed in order to apply employers NICs only, which would mean an undesirable delay.

If you agree with these proposals, it would be most helpful if you were able to make an early announcement, preferably early next week so that they could be referred to in the Finance Bill debate (Second Reading is on 26 April).

As for the timing of implementation, there is a great deal to be said for the measure taking effect from the day on which it is announced so as to avoid forestalling. I understand that NIC changes are normally subject to a significant delay in implementation to permit consultation with the Social Security Advisory Committee and to give employers plenty of warning, and also to allow for the full 21 day period during which the Orders are laid before Parliament. However, in this case, I do fear we would be criticised, and rightly, if we were to allow a period of weeks or months to pass before implementation. As for the employers' reaction, they cannot normally exploit advance warning of changes, such as those which arise from the annual review. Moreover, only a small minority of employers will be affected, and they will have the option of switching to payment by cash if they find the changes onerous.

There is one other point I should make about gilts. We have a legal obligation not to mislead potential purchasers of gilts. This means that, in the period before an announcement that the NIC exemption is to be removed, we have to be extremely careful about what is said on the scope of NICs. In particular, nothing should be said which might indicate that the scope of NICs would not be extended to cover gilts.

I very much hope you will be able to agree to these proposals and arrange for the necessary regulations to be made as soon as possible. In the meantime, no doubt our officials will continue to be in touch about the exact scope of the measure and the timetable for announcement and implementation.

NORMAN LAMONT

42/2.BTW.4375/38

CONFIDENTIAL

PMP

PS/CHX
PS/CST
SIR P MIDDLETON
MR ANSON
MR PHILLIPS
MR SCHOLAR
MRS LOMAX
MISS PEIRSON
MR PERETZ
MR CULPIN
MISS SINCLAIR
MR ILETT
MISS O'MARA
MR McINTYRE
MR RAMSDEN
MR CROPPER
MR TYRIE
MR P LEWIS (IR)
MR P JENKINS (T. SOL)
PS/IR.

Treasury Chambers, Parliament Street, SWIP 3AG

The Rt Hon John Moore MP
Secretary of State for Social Services
Department of Health and Social Security
Richmond House
79 Whitehall
LONDON
SW1A 2NS

18 April 1988

Dear John

NICS AND GILTS

Thank you for your letter of 24 March agreeing that we should take action to remove the NIC exemption on earnings paid in gilts and other securities. I have now considered the report which has been drawn up by our officials.

It seems to me that, on the question of coverage, there is no doubt that we need to go further than removing the exemption on gilts. Otherwise, the measure could all too easily be avoided by using other similar instruments. The most likely such means of avoidance are other debt instruments such as debentures, bonds, and local authority stock. I believe we should subject all these fixed and floating rate debt instruments (and the instruments which are derived from them, such as futures and options) to NICs.

I do not think we need extend NICs to equities, at least at this stage. There is no evidence that they are at present being used to avoid NICs. And I am concerned that, unless compelled to do so, we should not take action which might be seen as in conflict with our wider share ownership policy, particularly on employee shares. If, however, we were to find that equities were being widely used as an alternative to gilts for this purpose, we could then move against equities as well. Indeed, I would see some merit in making it clear, when the decision is announced, that we would not hesitate to extend NICs further if alternative instruments, such as equities or commodity contracts, were used.

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CONFIDENTIAL

If you agree with these proposals, it would be most helpful if you were able to make an early announcement, preferably early next week so that they could be referred to in the Finance Bill debate (Second Reading is on 26 April).

As for the timing of implementation, there is a great deal to be said for the measure taking effect from the day on which it is announced so as to avoid forestalling. I understand that NIC changes are normally subject to a significant delay in implementation to permit consultation with the Social Security Advisory Committee and to give employers plenty of warning, and also to allow for the full 21 day period during which the Orders are laid before Parliament. However, in this case, I do fear we would be criticised, and rightly, if we were to allow a period of weeks or months to pass before implementation. As for the employers' reaction, they cannot normally exploit advance warning of changes, such as those which arise from the annual review. Moreover, only a small minority of employers will be affected, and they will have the option of switching to payment by cash if they find the changes onerous.

There is one other point I should make about gilts. We have a legal obligation not to mislead potential purchasers of gilts. This means that, in the period before an announcement that the NIC exemption is to be removed, we have to be extremely careful about what is said on the scope of NICs. In particular, nothing should be said which might indicate that the scope of NICs would not be extended to cover gilts.

I very much hope you will be able to agree to these proposals and arrange for the necessary regulations to be made as soon as possible. In the meantime, no doubt our officials will continue to be in touch about the exact scope of the measure and the timetable for announcement and implementation.

Yours ever

Norman

NORMAN LAMONT

[redacted]RC/1511p

CONFIDENTIAL

~~Folder for next bilateral with Prime Minister (on 4/5)~~

25 APR 1989

(I shd inform PM @ next bilateral)

DEPARTMENT OF HEALTH AND SOCIAL SECURITY

Richmond House, 79 Whitehall, London SW1A 2NS

Telephone 01-210 3000

From the Secretary of State for Social Services

The Rt Hon Norman Lamont MP
Financial Secretary to the Treasury
HM Treasury
Parliament Street
LONDON
SW1P 3AG

FINANCIAL SECRETARY	
REC.	25APR1988
ACTION	Mr. McIntyre
COPIES TO	PPS, CST, PMG, EST Sir. P. Middleton Mr. Anson, Mr. Scholar Mr. Culpin. Mr. Peretz Miss. Peirson Mrs. Lomax Mr. Ilett Miss. Sinclair.

21 April 1988

Dear Norman.

NICs AND GILTS

Thank you for your letter of 18 April.

Although I am broadly content with what you propose I do have some misgivings about the limited scope of our action. There is, I think, a real possibility of a switch to equities. However, I fully accept that there would be presentational difficulties in moving against shares in the absence of evidence of their current misuse for NIC avoidance. We need to watch the situation closely to see if that evidence emerges as a result of our action and I will certainly make it clear in my announcement that we will take similar action against alternative means of NIC avoidance if we need to.

The very short timetable you propose presents us with problems and I would like to lengthen it somewhat. In taking the action proposed, my Department is dealing with subjects in which it has no expertise, and our lawyers' view here is that unless they are given more time to consult Departments more familiar with this ground and to consider the issues in greater depth there is a serious risk of defective drafting and subsequent challenge. I would therefore like us to aim for an announcement during the week beginning 9 May. I am sorry this is not as early as you would have liked but we must avoid the risk of ending up with faulty regulations.

Yours
John

JOHN MOORE

cc: Mr. Macpherson
Mr. Portes.
Mr. Cropper.
Mr. Jenkins OPC
Mr. Lewis IR
Mr. Evershed IR
[illegible]

ps3/16T

CONFIDENTIAL

PWP

FROM: J M G TAYLOR

DATE: 5 May 1988

PS/FINANCIAL SECRETARY

cc Sir P Middleton
Mr Culpin
Mr Peretz
Miss Peirson
Mrs Lomax
Mr Ilett
Mr McIntyre

NICs AND GILTS

The Chancellor mentioned this matter to the Prime Minister yesterday. The Prime Minister raised no objection to our intention to take action to remove the NIC exemption on earnings paid in gilts and other securities.

JT

J M G TAYLOR

FROM: J P MCINTYRE
DATE: 9 May 1988

FINANCIAL SECRETARY

cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mrs Lomax
Mr Peretz
Miss Peirson
Mr R I G Allen
Miss Sinclair
Mr Ilett
Mr Ramsden
Mrs Ryding
Mr P Hall
Mr Cropper
Mr Tyrie
Mr Call
Mr Evershed (IR)

NICS ON GILTS ETC

Mr Moore wrote to you on 21 April agreeing to your proposals for imposing NICs on gilts and other debt instruments, but said that he would not be able to make an announcement before this week.

2. The announcement is now planned for this Wednesday (11 May), with the new regulations coming into force the following day.

3. I attach a draft Press Notice and QA briefing which DHSS plan to put out on Wednesday. It reflects some comments we have made on an earlier draft; the Revenue and the DTI have also commented. (It is still subject to DHSS Ministers' comments.)

4. I would be grateful to know if you are content with the drafts.

JM

J P MCINTYRE

D.

B: 121

DRAFT PRESS NOTICE

NATIONAL INSURANCE CONTRIBUTIONS ON EARNINGS PAID IN GILTS (AND OTHER DEBT INSTRUMENTS)

The exemption from National Insurance contributions on earnings paid in the form of gilts and other debt instruments as well as their derivative instruments, is to be withdrawn from tomorrow, the Secretary of State for Social Services announced today. Answering a Parliamentary Question, he said:

> "There has been an increase in the practice of paying part of remuneration in gilts to Directors and other highly paid personnel. This is a device for avoiding National Insurance contribution liability. I have therefore today laid before the House regulations, The Social Security (Contributions) Amendment (No 3) Regulations 1988 withdrawing the exemption from National Insurance contributions which currently applies to gilts and other debt instruments. The regulations will have effect from tomorrow.
>
> Further action will be taken if it appears that other securities are being used to avoid National Insurance contribution liability".

The Secretary of State later added: "This device is not only unfair to the majority of employees and their employers whose National Insurance contribution liability is not reduced by this means. It also reduces income to the National Insurance Fund".

The effect of the regulations is that employers who continue to pay remuneration in these securities will need to include their market value at the time they are given to the employee, in an employee's gross pay for National Insurance contribution purposes

NOTES TO EDITORS

Regulation 19 (1) (d) of the Social Security (Contributions) Regulations 1979 allows payments in kind to be disregarded for National Insurance contributions purposes. This disregard has been taken to include any payments made in the form of gilts and other securities. The Social Security (Contributions) Amendment (No 3) Regulations 1988 remove the exemption from debt instruments and their derivative instruments. These include:

(i) securities such as debenture stock, bonds, loan stock (including convertible loan stock), and certificates of deposit, whether any of these are issued by a government, local or public authority, company or individual (ie all debt instruments); and

(ii) derivative instruments such as warrants, options and futures relating to debt instruments. Among the derivative instruments covered are unauthorised unit trusts holding debt instruments or their derivatives, but not authorised unit trusts.

ANNEXE E

(CONFIDENTIAL - UNTIL 11 MAY 1988)

QUESTION - Why do the regulations cover securities other than gilts?

ANSWER - Because restricting the scope of the regulations to transactions involving only gilt edged securities would make it all too easy to avoid liability for National Insurance contributions by using other debt instruments. The inclusion of all fixed and floating rate debt instruments in the terms of the regulations, and their derivatives such as futures and options on them, is aimed at eliminating the possibility of this type of avoidance.

QUESTION - Why haven't ordinary shares and authorised unit trusts been covered in the regulations?

ANSWER - There is no evidence at present to suggest that ordinary shares are being used as a method of payment which avoids National Insurance liability. Should this become apparent - and we are taking steps to monitor the situation - we will consider the introduction of further legislation.

QUESTION - Why are unauthorised Unit Trusts covered by the regulations?

ANSWER - Unauthorised Unit Trusts are not subjected to the detailed requirements of authorised Unit Trusts, such as spread of risk, and a Trust holding very few gilts could, for example, be set up just for NIC avoidance.

QUESTION - Is the Government going to impose NICs on all benefits in kind?

ANSWER - The Government has no plans to do so. Today's change is merely aimed at closing a loophole whereby payments with many of the characteristics of money are being used to avoid NICs.

QUESTION - What differentiates securities and other benefits in kind?

ANSWER - A gilt or similar security is readily marketable and the costs and risks involved in transaction are relatively small. Ownership of gilts has little, if anything to do with employment. By contrast, buying and selling a car for example involves considerable transaction costs and the use of a car could well be a legitimate condition of employment.

QUESTION - What evidence is there of abuse at present?

How much money is being lost?

ANSWER - Since the abolition of the upper earnings limit for payment of National Insurance contributions by employers it has become apparent as a result of survey work undertaken by Inland Revenue and the DHSS that securities (especially gilts) are being used by certain employers instead of paying employees in cash to avoid liability for National Insurance contributions.

The use of gilts for this purpose is becoming increasingly evident in survey and audit reports and in requests by accountants or employers for rulings on the liability for National Insurance contributions when using securities as an alternative to cash payment.

Precise figures on the extent of this practice are not available but the loss to the Exchequer is estimated already to be several million pounds a year. [If pressed: typically, the payments seem so far to have involved relatively few people but large individual amounts. Initial research by Inland Revenue has estimated that £20-30m of earnings were paid in this way in the 1986/7 tax year. This represents a loss to the Exchequer of the order of £2-3m. The full current loss is still under inquiry].

QUESTION - What if people switch to other methods of avoidance?

ANSWER - If other methods of avoidance become apparent the Government has the power to rectify the situation by amending the regulations.

QUESTION - Why burden employers with different valuation criteria in respect of the Inland Revenue and DHSS?

ANSWER - It is this Government's view that it is in the best interests of all concerned to endeavour, whenever possible to adopt a joint approach to the treatment of earnings by the Inland Revenue and the DHSS.

Under income tax legislation, the Inland Revenue will normally base their charge on either the cost to the employer or the value of the security to the employee,whichever is the greater. The definition of earnings used in DHSS legislation requires contributions to be assessed on the value of the payments to the employee and the regulations therefore introduce a method of valuation akin to the second method used by Inland Revenue.

QUESTION - How do the new regulations fit in with the Government's approach to de-regulation/burdens on business?

ANSWER - It has always been the aim of this Government to avoid introducing laws which place unnecessary burdens of administration on business.

The employers affected by these regulations are already going to the trouble of purchasing securities for their employees instead of paying them in cash. Employers would only be affected therefore if they were using this device. The vast majority of employers who are willing to meet in full their responsibilities in respect of the National Insurance Scheme will not be affected.

The introduction of these regulations will not therefore be at odds with the Government's stated approach on de-regulation.

Ch/ David Peretz reports that they did not feel constrained by the monthly target – rather by their view of what the market cd take at the moment – they would plan to do same more, once they've sold this lot.

MPW

SECRET

mp

From : D L C Peretz
Date : 26 May 1988

ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Mr Scholar
Miss O'Mara
Mr Grice
Mrs Ryding
Mr Cropper

Putting pressure.

Why is 80 so small? Is 80 a [illegible] [illegible]. At this stage given monthly targets that we be decisive.

NEW IG

As foreshadowed at your Funding Meeting yesterday, the Bank have now made a proposal to announce a new IG tomorrow.

2. This would be a new stock, for tender next Thursday. £400 million of IG 1994. 2% coupon (in line with coupons of other IGs of maturity up to 1996). <u>Not</u> FOTRA. Part paid, with a first instalment of £40 in June, and the balance in July.

3. The stock meets all our guidelines (including a subsidiary aim of extending the range of maturities of IGs). It will take the funding total for June above the £½ billion (net) target. But we need to do this to allow for the aim of buying in £½ billion of long conventionals in June.

4. I recommend that we agree this proposal.

DLP

D L C PERETZ

Minute needs redrafting. It shd (a) explain legal [illegible] (b) say that no sign that Japanese wish to make an issue of this, so we cd press [illegible] let this sleeping dog lie longer despite (a) above. (c) reassure them, if raised with Takeshita, [illegible] help [illegible] the Bank [illegible] [illegible] [illegible] Japanese will be allowed to open for business in Summit [illegible] problem on [illegible]

CONFIDENTIAL

From: Sir G.Littler
Date: 14 June 1988

Ch/ Content to minute PM as proposed? AS 14/6

MR ALEX ALLAN

c.c. Sir P.Middleton
Mr Scholar
Mrs Lomax
Mr Peretz
Mr Ilett

TOKYO STOCK EXCHANGE AND GEMMS

This submission reports the state of play, discusses what action we should take on GEMMS and when, and recommends a draft minute to the Prime Minister ahead of the Summit. It has been agreed with DTI and Bank of England.

State of Play

2. On the Tokyo Stock Exchange, developments since the visit here by Prime Minister Takeshita are:

- we have evidence that Takeshita himself has been pressing quite hard (on the Ministry of Finance Securities Bureau) for a solution to the BZW problem, although so far without finding a workable one;
- BZW are trying out on the Japanese authorities a fresh possibility suggested by the Bank of England (a kind of piggy-back membership in an existing seat); the first reaction from the Tokyo Stock Exchange authorities was negative; but when I took the opportunity recently of explaining the idea to Gyohten, he saw difficulties but did not rule it out; it is bound however to take a little time to explore.

CONFIDENTIAL

3. On GEMMS, Mr George has managed simply to hold off Nomura and Daiwa on the basis that he will not be able to talk to them again until after the forthcoming Summit.

Options on GEMMS

4. The basic options, with comments based on our latest legal advice, are:

- to invoke legal powers to withhold or delay, the most relevant being the 'reciprocity powers' under the Financial Services Act: but there could be legal doubts on this; and it would escalate the argument dramatically and perhaps incommensurately (interestingly BZW have said they would not want to be a cause of war on that scale!);
- to delay indefinitely without legal backing and without reasons which could be openly given: but the Bank of England (and/or Government) would be uncomfortably exposed then to criticism on judicial review;
- to find a suitable way of granting the applications while still keeping up pressure.

5. My guess is that Nomura will have sufficiently good legal advice to enable them to see weaknesses in our position if they are moved to probe it; they might of course decide as a matter of long-term strategy to avoid a conflict with the UK authorities - and lawyers do not wholly rule out the chance of the authorities being successful in defending a case - but the risks are great, and the DTI now join Treasury and Bank of England in recommending against taking them. (Our Ambassador in Tokyo does not know of the legal advice; I am arranging for him to be told).

6. What we recommend is that the Bank of England should - soon after the Summit - give approval without reservation but with a somewhat further delayed date for the opening of business, perhaps 1 August for the first, Nomura. The fact of approval being given would of course be made public immediately by the applicants, and we would need to be ready with replies to public questions. The applicants will certainly have registered that they would have been better treated if we had not had problems in Tokyo. And we should again make it clear to the Japanese that we are looking for the earliest possible solution to the BZW problem, and that any other Japanese aspirations in London may also be delayed as long as we are not satisfied. We need to consider how this will appear and how it relates to any possible further bilateral exchanges at the Summit this weekend.

The Summit

7. I think we want a friendly and relatively low-profile contact at the Summit. Of the two bilateral issues raised by the Prime Minister with Mr Takeshita in May, we have the prospect of an outcome on whisky which is acceptable - indeed the Prime Minister has welcomed it in her recent message to Mr Takeshita. On the Stock Exchange, we have no positive progress, but I am sure (particularly after talking with Gyohten last week) that we shall be told that efforts are continuing to be made, albeit without any clear indication yet of an early favourable outcome.

8. I recommend that our prime Minister should accept simply accept this, in terms which make it clear that we expect these efforts to continue until successful.

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Conclusion

9. Our recommendation is that the Bank of England should not contact Nomura and Daiwa until after the Summit, which is what the two firms have been led to expect. But they should do so, and give approvals on the lines indicated above, soon thereafter. Our position will be that:

- we have confirmed Japanese commitments to try to help, and we shall want to be able to indicate this publicly;
- we can invoke this in future (e.g. if the piggy-back idea looks promising but the Tokyo Stock Exchange authorities still need to be pushed);
- we shall have delayed the GEMM applications for a quite inconvenient length of time for the applicants, who have certainly drawn the moral;
- we shall be able (I have made this very clear to Gyohten) to choose our own timing of response to future wishes of the Japanese in London (e.g. regional banks, etc).

10. I enclose a draft of a short note to the Prime Minister, to offer guidance for any discussion with Mr Takeshita, and to explain how we now propose to handle the GEMM applications.

GL

(Geoffrey Littler)

CONFIDENTIAL

DRAFT MINUTE TO THE PRIME MINISTER

c.c. Trade and Industry Secretary
Foreign Secretary
Governor, Bank of England.

TOKYO STOCK EXCHANGE

I understand that you are not planning a special bilateral during the Toronto Summit with Prime Minister Takeshita, following your full talks with him here only a few weeks ago.

2. Of the two bilateral issues you raised with him, steps have been taken on whisky which we have welcomed. This minute is to tell you where we stand on the Tokyo Stock Exchange and how I suggest, with the agreement of the Bank of England and DTI, that we should handle this and the related question of applications by two Japanese firms to become Gilt-Edged Market Makers in London.

3. There has been no real progress in breaking the impasse of the limit on Tokyo Stock Exchange seats to enable BZW to be given a clear prospect of membership within a reasonable time. However it is clear that Prime Minister Takeshita himself has indeed, as he promised you, been actively pressing the Japanese authorities to try to help. We think he will continue to do so and - though we still have no guarantee that he will succeed - it seems right that you should take the opportunity to welcome his efforts and of course urge that he persevere until they do succeed.

4. Meanwhile, we have to decide what to do about the two outstanding Japanese applicants for GEMM status here. You were careful in your talks with Takeshita last month not to draw any

particular link between the BZW case and GEMM applications, but simply indicated in a general way that delays in Tokyo might result in delays in London also. The GEMM applications have now already been delayed for many months. For the Bank of England to delay much longer would be unreasonable in terms of any normal practice, excessively severe in the light of evidence of Prime Minister Takeshita's efforts, and risky in judicial review terms in the absence of legal powers - and we are all agreed that to try to invoke the DTI's reciprocity powers in this case would be to escalate the argument beyond reason and put more at risk than we could hope to gain.

5. Our proposal therefore is that, after the Summit, the Bank of England should give staged future dates for actual opening of business for Nomura (say, 1 August) and later for Daiwa. These companies would of course have to be free to announce the news as soon as they were told. We would of course remind the Japanese authorities that there could be delays on other matters as long as the British continue to face delays in Tokyo, and we know that they are concerned about some future questions of more importance to them than the GEMM applications.

6. It will be helpful if, in public answers to questions about this, we are able to indicate that Takeshita has at least renewed his general assurance of willingness to try to find a solution to the Stock Exchange problem.

I am copying this minute to David Young, Geoffrey Howe and the Governor of the Bank of England.

(N.L.)

CONFIDENTIAL

cc- Sir G. Littler
Sir P Middleton
Mr Scholar
Mrs Lomax
Mr Peretz
Mr Flett

PRIME MINISTER

TOKYO STOCK EXCHANGE

I understand that you may not be having a special meeting during the Toronto Summit with Prime Minister Takeshita, following your full talks with him here only a few weeks ago. Nevertheless, you will wish to know how matters stand, now that whisky has been settled, on the second of the two bilateral issues you raised with him when he was here. This minute therefore sets out where we stand on the Tokyo Stock Exchange and how I suggest, with the agreement of the Bank of England and DTI, that we should handle this and the related question of applications by two Japanese firms to become Gilt-Edged Market Makers in London.

There has been no real progress in breaking the impasse of the limit on Tokyo Stock Exchange seats to enable BZW to be given a clear prospect of membership within a reasonable time. However it is clear that Prime Minister Takeshita himself has indeed, as he promised you, been actively pressing the Japanese authorities to try to help. We think he will continue to do so and - though we still have no guarantee that he will succeed - it seems right that you should take the opportunity to welcome his efforts and of course urge that he persevere until they do succeed.

Meanwhile, we have the unresolved question of the two outstanding Japanese applicants for GEMM status here. You were careful in your talks with Takeshita last month not to draw any particular link between the BZW case and GEMM applications, but simply indicated in a general way that delays in Tokyo might result in delays in London also.

We need to handle this carefully. The legal ice is thin. We have already delayed the GEMM applications for many months. For the Bank of England to delay implementation much further might not stand up to judicial review. And I understand that David Young judges that to attempt to use the 'reciprocity powers' in the Financial Services Act would be a mistake: he is inclined to the view - which seems right to me too - that to declare open war in this way on this issue would expose us to risks for other British interests against little chance of success on BZW, so that he could not be satisfied that it was justified in the overall public interest.

My own judgement is that the Japanese would be unlikely to try to test us - they have taken the whole matter quietly so far and would probably reckon that to take issue publicly or legally with HMG on a point which does not matter greatly to them would be disadvantageous to them in the longer term.

Nevertheless, if it would help your relations with Prime Minister Takeshita, and if in other respects they are going well, you might indicate, in response to adequate assurances of his continued efforts, that you would expect the Bank of England to be telling Nomura and Daiwa fairly soon when they will be allowed to open for business as GEMMs.

Our procedure then would be that, fairly soon after the Summit, the Bank would give staged future dates, say 1 August for Nomura and later for Daiwa. The companies would of course have to be free to announce the news as soon as they were told. At the same time we would make it clear again to the Japanese authorities that there could be delays on other matters as long as the British continue to face delays in Tokyo, and we know that they are concerned about some future questions of more importance to them than the GEMM applications.

We shall of course want, in public answers to questions about this, to be able to indicate that Takeshita has at least renewed his general assurance of willingness to try to find a solution to the Stock Exchange problem.

I am copying this minute to David Young, Geoffrey Howe and the Governor of the Bank of England.

[N.L]
17 June 1988

[Text approved by the Chancellor;
signed in his absence]

CONFIDENTIAL

(Not sure whether this was sent)

PRIME MINISTER

Tokyo Stock Exchange

1. I have seen the Chancellor of the Exchequer's minute of 17 June. I understand the risk of judicial review. But I consider that the Chancellor is right in his judgement that the Japanese would be unlikely to try to test us.

2. I also agree that it would be right to speak to Prime Minister Takeshita if you get the opportunity during the Summit in Toronto. He has not yet replied to the letter you sent him after his visit to London, and the very fact of your enquiry will help to keep up the pressure. You will wish to judge the tactics for yourself. But my own view is that the Japanese will meet us if we are firm. It would therefore be wrong for you to indicate, as early as this weekend, that we now expect that Daiwa and Nomura will get the green light soon.

3. I am copying this minute to the Chancellor of the Exchequer, the Secretary of State for Trade and the Governor of the Bank of England.

(GEOFFREY HOWE)

Foreign and Commonwealth Office

CONFIDENTIAL

10 DOWNING STREET

LONDON SW1A 2AA

CH/EXCHEQUER

REC.	20 JUN 1988 ✓ 20/6
ACTION	SIR G LITTLER
COPIES TO	SIR P MIDDLETON
	MR SCHOLAR
	MRS LOMAX
	MR PERETZ
	MR ILETT

From the Private Secretary 18 June 1988

bf. 23/6

Dear Alex.

TOKYO STOCK EXCHANGE

The Prime Minister has considered the Chancellor's minute of 17 June in which he suggests that the Prime Minister might indicate to Mr. Takeshita in Toronto that, in response to adequate assurances he will continue to press the Tokyo Stock Exchange authorities to make more seats available for British firms, she would expect the Bank of England to be telling Namura and Daiwa fairly soon when they will be allowed to open for business as Guild-Edged Market Makers. She thinks this would simply take the pressure off the Japanese and would not be wise in present circumstances. She does not, therefore, prpose to speak in this sense to Mr. Takeshita.

I am copying this letter to Stephen Ratcliffe (Department of Trade and Industry), Lyn Parker (Foreign and Commonwealth Office) and John Footman (Office of the Governor of the Bank of England).

Yours sincerely,

Charles Powell

(C. D. POWELL)

Alex Allan, Esq.,
HM Treasury.

CONFIDENTIAL

Ch

You told Gov you would raise this with PM; if no progress then meeting with Lee, you, Gov and ? Lord Young.

AA

PERSONAL AND CONFIDENTIAL

NOT TO BE RETURNED FOR FILING ETC

From: Sir G.Littler
Date: 23 June 1988

CHANCELLOR

GEMMS AND THE JAPANESE

You will have a chance to discuss this tomorrow with the Governor. As far as I know, the Prime Minister had no relevant talk with Mr Takeshita during the Toronto meetings - matters rest with her Private Secretary's letter of 18 June (copy attached), which leaves us in an uncomfortable position on two counts: procedure and substance. (I am putting this to you on a personal basis, not for the file and not copied, because of paragraphs 6-8).

Substance

2. If we refuse, or indefinitely delay, the two Japanese GEMM applications, it is probable that the applicants will simply lose interest for the time being and close down the preparations they have made. That will leave us with no pressure on the Japanese authorities on this front. I have to advise that I see no real likelihood that the Japanese reaction would be favourable to our Tokyo Stock Exchange demands.

3. There is to my mind a by no means negligible risk that the reaction of the Japanese authorities will be unfavourable, quietly but none the less damagingly. The main example might well be that they decide not to offer us anything like what we want in their their prospective round of decisions on whether and how far to permit discretionary management of important pension funds by foreign, especially British, firms in Tokyo. But they could be

unhelpful in other ways too, affecting the success of established British interests in Tokyo. This is why David Scholey and others are very worried about our threat over GEMMs: of course the BZW discomfort is no problem for them, but they are genuinely fearful of the risk of Japanese unhelpfulness in Tokyo where the foreigner still feels very exposed. (I think it was Scholey personally who persuaded Lord Young that he could not certify use of the F.S. Act as being in the overall public interest).

4. In short, we are not bargaining from strength (as I have always tried to do in our bilateral talks) and may end up by finding that we have penalised ourselves.

Procedure

5. Although perhaps unlikely, it is by no means impossible that one of the two Japanese houses applying for GEMMs could try to challenge a refusal or further indefinite delay. They will not lack legal and constitutional advice, and our case is not strong.

6. Against this background, I think you will find that the Governor has been strongly advised that he needs an explicit written instruction if the Bank is to refuse or delay further. The Bank is effectively exercising a Public Law function in this matter and would have no ground on which to defend itself in the absence of an authoritative instruction.

7. However, I think that the Treasury Solicitor will advise you against sending such an instruction without legal backing - since this could expose the Treasury to precisely the challenge

and criticism that would otherwise be levelled at the Bank.

8. Finally, the only route of legal backing is to invoke the 'reciprocity powers' of the Financial Services Act. This is an action for the Trade and Industry Secretary and I understand that he, after careful consideration of legal advice and the facts of the case, is disinclined to have anything to do with it.

Parliamentary Question

9. Jock Bruce-Gardyne has repeated his earlier question, down now for 28 June. Nick Ilett has put up a "nothing to add" draft reply which will do unless we have moved differently by then.

Conclusion

10. My advice remains that we should let the Bank now tell both Japanese houses that they can be authorised, with delayed dates for actual opening of business. But I think we shall have to clear this with the Prime Minister first. You may want to discuss after you have talked with the Governor.

(Geoffrey Littler)

91/G 4317/016/cc

COVERING SECRET

FROM: CATHY RYDING

DATE: 23 June 1988

ECONOMIC SECRETARY

BF 24/6

cc Chancellor
Sir p Middleton
Sir G Littler
Sir T Burns
Mr Scholar
Mr Peretz
Miss O'Mara
Mr Grice
Mr Rich
Ms Bronk
Mr Wheatley
Mr Cropper

Mr Patterson)
Mr Wilson) - B/E
Mr Plenderleith
Prof Griffiths - No 10

I shd be grateful for a note ASAP on the pros & cons of a return to over-funding ASAP given (a) the forecast [illegible] crisis & [illegible] (b) the overfunding [illegible] a bill mountain problem.

FUNDING MEETING

There are three items on the agenda for the meeting on Monday 27 June:

(i) Funding arithmetic
(ii) National Savings
(iii) Gilt Edged Funding

2. I attach papers on these items, together with a note on cost of funding*. I also attach a paper by the Bank on their proposals for the next auction.

* To be circulated tomorrow.

Cathy Ryding

CATHY RYDING

eog5.ay21.6cr

SECRET

FUNDING ARITHMETIC 1988-89

(Note by MG)

1. This note discusses the total funding requirement for the current financial year, based on an M4 funding rule.

2. The attached table shows the main elements of the arithmetic. In line with the June forecast the table assumes a PSBR surplus of £7.4 billion. This is a £4.2 billion larger surplus than assumed in last month's arithmetic. Intervention in April and May amounted to +£0.6 billion, and we are expecting to publish a small positive for June. However, in line with the decision taken at the April Funding meeting, this is assumed to be offset during the remainder of the year to give a financial year figure of zero. This is in contrast to the June forecast which assumes a run down in the reserves over the year as a whole of £1 billion.

3. National savings are assumed to contribute £1 billion over the full year. CTDs are assumed to be run down by £1 billion, in line with a policy of setting rates significantly below LIBID.

4. On these assumptions the arithmetic implies a gross gilt sales task of £1.4 billion for the year as a whole, a £4.1 billion reduction on the requirement shown in last month's arithmetic. This leaves £0.5 billion sales to be achieved between June and March 1989, an average of £47 million a month. Gilt sales in June so far total -£150 million, which together with the second call of last month's tender gives +£275 million for the month as a whole if there are no further sales or purchases. This leaves £200 million of sales to be achieved over the remainder of the year. However, two planned auctions of up to £1 billion each and around £½ billion of IGs on the Bank's books which we are hoping to sell, implies a buying in requirement of at least £2 billion if a full fund is to be achieved.

5. The PSBR is forecast to continue in substantial surplus in 1989-90 and 1990-91 with net gilt sales projected of around -£10 billion in each year. This is considerably more negative than we had been previously forecasting. These figures can be no more than illustrative. They obviously depend upon the fiscal adjustment which in the event is made, though the forecast makes an allowance for this. Even so, it seems clear that the funding requirement will remain very light for some time to come.

SECRET

FUNDING : FINANCIAL YEAR 1988/89 21/6/88

£ million

		FORECAST Financial Year 88/89	OUTTURN April - May 88	RESIDUAL Jun 88 - Mar 89	
PSBR AND FUNDING TARGET					
1	PSBR excl asset sales	-2400	996	-3396	
2	Asset sales (sales-)	-5000	-2748	-2252	
3	PSBR	-7400	-1752	-5648	
FINANCED BY:					
4	OPS debt sales to M4ps (sales-)	600	118	482	
5	National Savings (sales-)	-1000	-221	-779	* -78
6	CTDs sales to M4ps (sales-)	1000	151	849	
7	Treasury bills etc M4ps (sales-)	0	78	-78	
8	Intervention (reserves inc+)	0	605	-605	
9	Public sector externals excl intervention and gilts (inc-)	0	18	-18	
10	NET GILT SALES TO M4PS & OVERSEAS NEEDED FOR FULL FUND (sales+)	-6800	-1003		
11	Adjustment for 1987/88 underfund	400			
12	OVER(-)/UNDER(+)FUNDING	-400	-1195	795	
GILT SALES:					
13	Net purchases by M4ps and overseas (purchases+)	-6400	192	-6592	
14	Net purchases by banks/b socs & other public sector (purchases+)	-500	-749	249	
15	Maturities	8300	1483	6817	
16	GROSS OFFICIAL SALES	1400	926	474	
17	Monthly average gross gilt sales	117	463	47	

* average per month

Relationship between lines:

3 = 1 + 2
10 = 3+4+5+6+7+8+9
12 = 10 + 11 - 13
16 = 13 + 14 + 15

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NATIONAL SAVINGS

(Note by MG1 Division)

1. This note reports the latest results, and summarises DNS' forecasts for the 3 months to end-August 1988. Detailed figures are shown in the attached table.

Results for May 1988

2. There was a total net inflow of £63 million (compared with £157 million in April). The following points are of particular interest:

(a) The largest inflow (£130m) is still from Income Bonds, but sales are lower and repayments higher than in April (£159m).

(b) The next largest inflow (£58m) is from Investment Account (down somewhat from the £65m in April).

(c) The Income Bond fall-off reflects the 1½% reduction in interest on 1 May, and no major new publicity.

(d) Savings certificates sales (including a strong component of reinvestment of matured certificates) have picked up, but there is still a large net outflow (£159m). This is attributable mainly to repayments of matured certificates following the reduction of ¾% in the General Extension Rate from 1 May.

Forecasts to end-August 1988

3. On the assumption of no interest rate changes in the period, DNS forecast a net inflow of £234 million. This would give a total of about £450 million for the first five months of 1988-89, and indicates that DNS have made a successful transition to the much lower total expected of them this year. At present, they are on course for a total of about £1 billion.

4. A number of events will affect the final outcome, most notably:

(a) the course of interest rates over the coming months, and the position in the competitive league decided for National Savings;

(b) outflows from index-linked certificates following the payment of this year's supplement to holders of the first and second issues;

(c) outflows from matured fixed interest certificates, the amount of which will depend <u>inter alia</u> on the level of the GER;

(d) take up of the new product which is to replace Deposit Bonds later in the year.

HM TREASURY
MG1 Division
22 June 1988

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FUNDING FORECAST JUNE 1988 TO AUGUST 1988

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TABLE D1: ANALYSIS BY PRODUCT

£ million

	MAY			JUNE			JULY			AUGUST			3 MONTHS TOTAL CONTRBTN	AMOUNTS INVESTED AT END OF AUG	
	NET INFLOW	GROSS ACCRUED INT	TOTAL	NET INFLOW	GROSS ACCRUED INT	TOTAL	NET INFLOW	GROSS ACCRUED INT	TOTAL	NET INFLOW	GROSS ACCRUED INT	TOTAL			
NSC FIXED INTEREST	-222	73	-149	-200	70	-130	-175	70	-105	-175	70	-105	-340	12,485	[of which £7,300m matured certificates]
NSC INDEX LINKED	-25	16	-9	-5	55	50	0	5	5	-60	110	50	105	3,635	[of which £2800m matured certificates]
INCOME BONDS	130	0	130	115	0	115	70	0	70	75	0	75	260	7,530	
DEPOSIT BONDS	10	6	16	8	6	14	5	6	11	8	6	14	39	879	
INVESTMENT ACCOUNT	8	50	58	-10	50	40	-15	50	35	-15	50	35	110	7,588	
ORDINARY ACCOUNT	-9	3	-6	-8	3	-5	-8	3	-5	-8	3	-5	-15	[illegible],681	
YEARLY PLAN	8	3	11	10	2	12	10	2	12	10	2	12	36	479	
PREMIUM BONDS	14	0	14	14	0	14	14	0	14	14	0	14	42	2,151	
SAYE	-3	3	0	-3	2	-1	-3	2	-1	-3	2	-1	-3	464	
TOTAL DNS	-89	154	65	-79	188	109	-102	138	36	-154	243	89	234	36,892	

Total contribution to end August=220m +£234m=£454m

DEPARTMENT FOR NATIONAL SAVINGS
STATISTICS BRANCH 01 605 9316
16 JUNE 1988

0322J/MAB SECRET 23.6.88

GILT-EDGED FUNDING £ million
(Note by Bank of England)

1 This note reviews the funding outturn so far in 1988/89 and the outlook from July onwards.

Funding Arithmetic

2 Tables 1 and 2 show (unadjusted and seasonally adjusted, respectively) the funding outturn in the first two months of 1988/89 and a revised forecast for the year as a whole which is consistent with the latest Treasury economic projections. The full year forecast shows one major revision from last month - an increase in the PSBR surplus from 3200 to 7400 - and one minor revision - an increase from 300 to 400 in the adjustment required to offset last year's underfund (reflecting revisions to back figures). With the forecast for the other financing items remaining the same, these changes feed through to a sharp cut, from 5500 to 1400, in the total of gross gilt sales required this year, producing an average striking rate of little more than 100 per month.

3 In April and May together gross official gilt sales totalled 930 (table 3 shows the sectoral take-up), leaving less than 500 for the remainder of the financial year. Taking into account the 250 of gross sales secured so far in June - mainly the net result of the call of some 400, and 140 of buying in of long-dated stock - the remaining funding requirement on this arithmetic for the final nine months of the year is for gross sales of 200 (of which 100 are already accounted for by the July call on sales of the 1994 index-linked stock) plus the amount necessary to cover any further buying in.

4 However, this figuring is highly uncertain, as attested by the revision already made to the PSBR forecast. The PSBR remains one of the largest unknowns in the funding arithmetic, and could turn out to be considerably different from the forecast. Last year, successive downward revisions to the PSBR projections were offset

by upward revisions to the rise in the reserves. In April and May this year the reserves rose by 600, which is assumed to unwind over the rest of the year. But against the background of increasing domestic inflationary pressures, short term interest rates are more likely to rise than fall, which casts doubt on both the direction and magnitude of the assumed reserve change; any further rise in the reserves would add further to the funding requirement. Higher funding would also be required if the other public sector (OPS) continues to run-off its net indebtedness to the M4 private sector. In April and May there was a run-off of 650 in seasonally adjusted terms, 50 more than the forecast for the full year. This apparent acceleration in repayments by the OPS may reflect some catching up after a much lower than forecast outturn at end of last year, in which case this year's total might very well emerge higher than the current forecast. The reduction of 500 forecast in bank and building society gilt holdings in 1988/89 also remains very uncertain, particularly in view of past volatile movements. Though the fall of 750 in the first two months of the year is not inconsistent with the full year forecast it is conceivable that the outturn for 1988/89 could be quite different, in either direction.

5 Despite these these uncertainties the latest arithmetic suggests that the funding need over the rest of the year will be less than earlier forecast. If we were to undertake no further buying in, the two auctions scheduled for the rest of the year would likely be sufficient to cover our remaining needs even if the uncertainties reviewed above were to veer in the direction of adding to the funding need. But, in the other direction, the prospect in the immediate period ahead of interest rates continuing to edge upwards suggests that we may have opportunies to continue buying in on the stepped-up scale we have achieved over the past month, both in the longer-dated area and in the three years of bunched maturities in 1996/97 - 1998/99. In addition, we would want too take the opportunity of the reduced funding need implicit in the latest arithmetic to begin to buy in next year's peak of maturities which at £12.4 billion (virtually all still in market hands) is sharply higher than this year's total of £8.3 billion.

On this basis we envisage continuing to take the opportunity for limited gilt sales outside the auctions, particularly when there is demand for indexed stock. This would also be useful in avoiding any abrupt deterioration in market liquidity which could put up our long-run cost of funding. The extent of sales, even on this limited basis, would clearly need to be responsive to the state of the market and the evolution of the funding arithmetic; all this implies that any need to supply stock (other than the auctions) is likely to take the form of occasional tranchettes rather than new issues by tender.

7 With regard to buying in, we feel that we have had the opportunity to make useful progress over the past month: the market is steadily becoming more used to offering stock to us in periods of weakness, and market conditions this month have encouraged them to do so. So far in June we have bought in about 140, all but 10 of it long-dated stock. This takes the total for the year so far to 230, of which 160 are longs and 70 are mediums (mainly in the three years of bunched maturities in the late 1990's). The average life of stock bought in so far in 1988/89 is around 14 years. The market as a whole has not yet clearly perceived a deliberate pattern to our operations, which is important if we are to avoid the impression of setting a floor. For this reason we are likely to continue to have the best chance to buy in during periods of weakness, which is also when the terms are most in our favour.

Market conditions and funding tactics

Yields %	8 May 87 (trough)	19 Oct 87 (peak)	25 May 88 (last funding meeting)	22 June 88
Shorts	8 5/16	10 9/16	8 7/8	9 5/16
Mediums	8 11/16	10 9/16	9 5/16	9 1/2
Longs	8 3/4	10 1/16	9 3/16	9 5/16
IGs (2006) (real yield at 5% inflation)	3 5/8	4 11/16	3 7/8	3 7/8

8 Compared with a month ago there has again been relatively little change in long gilt yields despite a change in short interest rates. The relative stability of long yields reflects

the view that interest rates were previously at unsustainably low levels. Short yields have risen sharply since last month, reflecting the increase in interest rates, giving a much flatter yield curve (see chart). Though long yields are now only slightly above the level of a month ago the long end of the market has not been so featureless as it had been earlier. Longs advanced by about two points (equivalent to a fall of around 1/4% in terms of yield) by the middle of June, partly in response to developments abroad, particularly the better than expected US trade figures and the long bond's subsequent advance. A run of poor domestic indicators, pointing to higher future inflation, has since set the market back, with its previous gains now having been more than reversed. Index linked stocks benefitted from the general market advance in mid-June but have held their ground better than conventionals in the subsequent retreat, reflecting the worse news on inflation prospects.

9 So far this financial year, the favourable technical position in the gilt market, following from the PSBR surplus, has resulted in little change in long yields. This has reflected two main factors. The first has been the deterioration in the fundamentals as revealed by successive economic indicators, which have pointed towards a worse inflation outlook. The second has been that the gap left by fewer gilt issues has been filled by non-gilt bond issues, mainly in eurosterling form. Fixed-rate issues of this type amounted to some 2600 in the second half of last year, while so far in 1988 there have seen issues of 6500.

10 If the indicators over the next few weeks continue to show a deterioration in the fundamentals, the market may begin to push long rates upwards, though it is unclear to what extent this would be offset by a possible reduction in the supply of non-gilt issues. The upward drift in yields might be reinforced if there are further increases in short term interest rates, especially if this were in response to adverse economic indicators.

11 Our current conventional book, excluding stock bought in and near maturities, is almost nil, so that our holdings consist largely of index linked stock. This totals some 400, of which some 200 is the 1994 maturity and 100 is the 2020. We have no debt outstanding to NILO.

12 Against the above background, we will look to sell index linked stock when possible and will aim to operate in conventional stocks on the basis described above, with limited sales and buying-in focused on the long end and the peaks of maturities next year and in the late 1990s. The considerations relevant to the timing of the next gilt edged auction, which we suggest should be on August 10, are set out in a separate note.

Bank of England
23 June 1988

U0893(page 11)
Table 1

SECRET

22. 6.88

FUNDING : FINANCIAL YEAR POSITION 1988/89 M4 BASIS £ millions
Not seasonally Adjusted

	FORECAST	OUTTURN APRIL - MAY 1988	RESIDUAL JUNE 1988 - MARCH 1989
PSBR AND FUNDING TARGET			
1 PSBR excl asset sales	-2400	996	-3396
2 Asset sales (sales-)	-5000	-2748	-2252
3 PSBR	-7400	-1752	-5648
Financed by:			
4 Other public sector net debt sales to M4PS (sales-)	600	118	482
5 National Savings (sales-)	-1000	-221	-779(-78)a
6 CTDS (sales-)	1000	151	849
7 Treasury bills etc M4PS (sales-)	0	78	-78
8 Intervention (reserves inc+)	0	605	-605
9 External finance of public sector excluding intervention and gilts (increase-)	0	18	-18
10 Target net gilt sales to M4PS and overseas for full fund (sales+)	-6800	-1003	-5797(-580)a
11 Adjustment for 1987/88 underfund	400		
12 Over (-)/Under (+) funding	-400	-1195	795
GILT SALES			
13 Net purchases by M4PS and overseas (purchases+)	-6400	192	-6592
14 Net purchases by banks, b. socs and other public sector (purchases+)	-500	-749	249
15 Maturities	8300	1483	6817
16 GROSS OFFICIAL SALES	1400	926	474
17 Monthly average gross gilt sales	117	463	47

a Monthly average

Relationship between lines:
3 = 1 + 2
10 = 3 + 4 + 5 + 6 + 7 + 8 + 9
12 = 10 + 11 - 13
16 = 13 + 14 + 15

22. 6.88

SECRET

0089J(page 13)
Table 2

FUNDING : FINANCIAL YEAR POSITION 1988/89 — M4 BASIS — £ millions
Seasonally adjusted

	FORECAST	OUTTURN APRIL - MAY 1988	RESIDUAL MAY 1988 - MARCH 1989
PSBR AND FUNDING TARGET			
1 PSBR excl asset sales	-2400	- 189	-2211
2 Asset sales (sales-)	-5000	-2748	-2252
3 PSBR	-7400	-2937	-4463
Financed by:			
4 Other public sector net debt sales to M4PS (sales-)	600	645	- 45
5 National Savings (sales-)	-1000	-225	-775(-78)a
6 CTDS (sales-)	1000	40	960
7 Treasury bills etc M4PS (sales-)	0	67	-67
8 Intervention (reserves inc+)	0	605	-605
9 External finance of public sector excluding intervention and gilts (increase-)	0	46	-46
10 Target net gilt sales to M4PS and overseas for full fund (sales+)	-6800	-1759	-5041(-504)a
11 Adjustment 1987/88 underfund	400		
12 Over (-)/Under (+) funding	-400	-1951	1551
GILT SALES			
13 Net purchases by M4PS and overseas (purchases+)	-6400	192	-6592
14 Net purchases by banks, b: socs and other public sector (purchases+)	-500	-749	249
15 Maturities	8300	1483	6817
16 GROSS OFFICIAL SALES	1400	926	474
17 Monthly average gross gilt sales	117	463	47

a Monthly average

Relationship between lines:
3 = 1 + 2
10 = 3 + 4 + 5 + 6 + 7 + 8 + 9
12 = 10 + 11 - 13
16 = 13 + 14 + 15

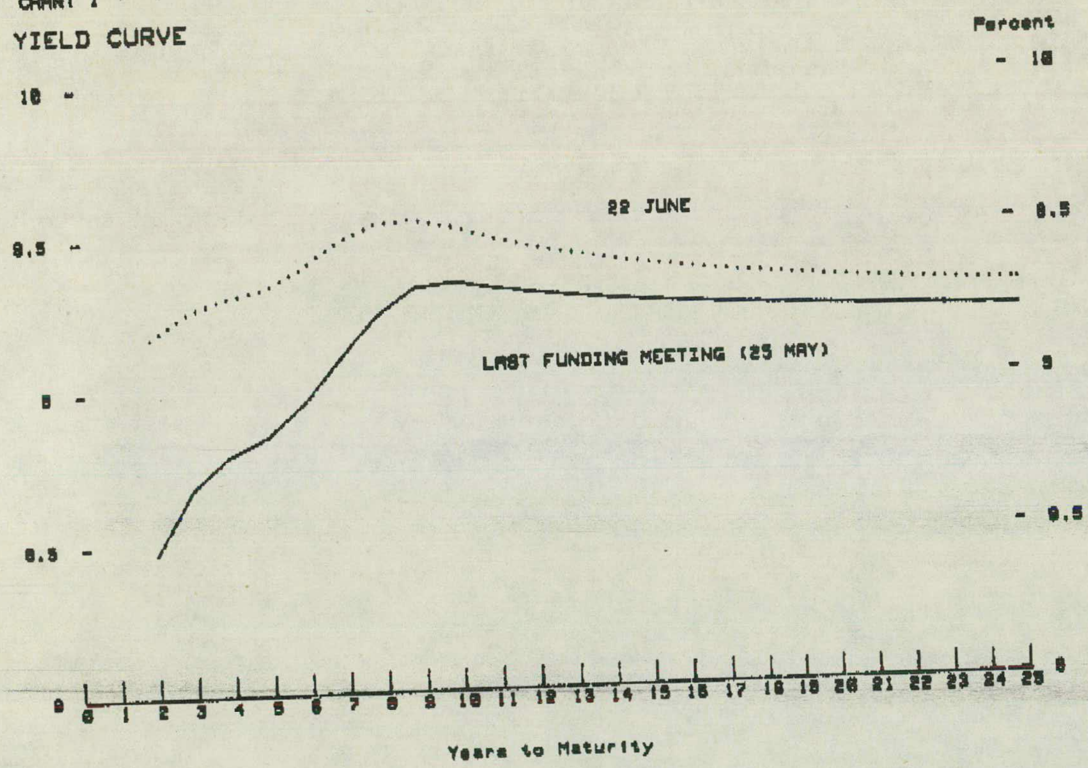
TABLE 3: GILT TRANSACTIONS (£ million)

	1987/88	1987			1988					
	Year	April-June	July-Sept	Oct-Dec	Jan	Feb	Mar	Apr	May	June(1)
Gross Sales	13459	3965	2630	3785	1709	1074	292	707	219	250
o/w buying in (3)								(-21)	(-65)	(-143)
Maturities	-6456	-2609	-1185	-1279	-360	-43	-976	-507	-976	-720
Net Official sales(2)	7003	1356	1445	2506	1349	1031	-684	200	-757	-470
Purchases (+) by:										
Banks (2), (4)	- 398	-1441	291	-7	620	6	133	-886	-236	n/a
Building Societies	- 414	76	248	-526	143	-146	-207	117	256	n/a
Overseas	4884	1725	2331	546	238	313	-269	311	-16	n/a
M4 private sector	2931	996	-1425	2495	348	858	-341	658	-761	n/a

(1) To 2 1/6 only; sales figures include known calls already secured.
(2) Excluding repos.
(3) 1988/89 only; Bank purchases (-).
(4) And other public sector.

CHART 1

YIELD CURVE



ANNOUNCEMENT OF THE NEXT GILT-EDGED AUCTION
(Note by the Bank of England)

1 The press notice on auctions in 1988/89 which we issued in April stated that the next auction of gilt-edged stock would be in July or August. It also stated that we would announce the precise auction date and the maturity area of the stock not less than a month in advance.

2 An announcement in the past few weeks, for an auction in the first half of July, would have been difficult against the background of the recent nervousness in the exchange market and the ensuing increases in base rates, which triggered a marked shift in the slope of the gilt yield curve. But we need now to consider the date and the broad details of the auction.

3 In considering the date of the auction, we have looked both at the likely timing of the relevant economic statistics and at the pattern of the institutions' main cash inflows: the two attached tables summarise this information.

4 In terms of statistics, the second halves of both July and August are relatively heavily filled with important announcements, including US trade figures in the middle of each month and the UK trade figures at the end. Specifically, an auction in the second half of July looks awkward because of the money figures on Wednesday, 20 July, and the UK trade figures a week later on Wednesday 27 July. Similarly, the second half of August (quite aside from being the holiday season) is awkward because of the US trade figures on Tuesday 16 August, followed by the UK money figures later the same week (Thursday, 18 August) and UK trade figures the following week (Thurday, 25 August). By contrast, statistics in the first half of August are comparatively sparse in both the UK and the US: the first two weeks of August provide quite good openings.

5 The profile of cash flows provide a further reason for not having had an announcement in the past few weeks of an auction in the first half of July, since the major flow of gilt dividends occurs in the second half of July and, to a less extent, in August. Moreover, there is already a small gilt call (IG 1994) scheduled for 18 July. The forthcoming redemption on 1 July of 3% British Transport 1978/88, heavily held by persons, may have less effect on demand for the auction stock than gilt dividends received by institutions. Of more importance will be the second call on BP, amounting to over £2 billion, which is scheduled at the end of August; this gives further reason to hold the auction early in that month.

6 On this basis we think that the sensible choice of date is between Wednesday 3 August and Wednesday 10 August. The second of these dates has the advantage that we would announce the precise details of the stock on a day (the previous Tuesday, 2 August) relatively free of major statistical releases, whereas an announcement for an auction on 3 August would come just ahead of the release of UK trade figures on Wednesday, 27 July, which could prove awkward depending on how the figures turn out. 10 August has the slight awkwardness that it coincides with the US quarterly refunding expected on 9, 10 and 11 August, but we do not think this need be a serious inhibition to our auction. On balance, therefore, our proposal would be to hold the auction on Wednesday 10 August, with the preliminary announcement of the date and the maturity area of the stock to be made on Friday, 8 July (a month in advance, as we have already undertaken) and the final details (amount, choice of stock, etc) being annouced on Tuesday, 2 August.

7 Although we are not under any sort of funding pressure, the choice of stock will nonetheless be important to the success of the auction. We think that we should aim to bring a further tranche of an existing stock, in order to enhance liquidity in the area chosen; this is a preference which a number of market participants have expressed to us. But we also think that we should avoid bringing a further short, since the last two issues (£800 million of 8 1/2% Treasury 1994, on 16 March, and £800 million of 8 1/4% Treasury 1993, on 25 May) were both shorts

and that area has subsequently suffered most from the two recent increases in base rates: the 1993 issue was, as a consequence, traded at up to a point below where we sold it. We think we should instead look to the medium-dated area, where the best choice, if we are to avoid the years of very heavy maturities in 1996/97 - 1998/99, would be a further tranche 8 1/2% Treasury 2000 or 9% Conversion 2000: both these are FOTRA stocks, but this can be less of a concern now that the exchange rate has eased back from its higher levels. The amounts in issue of each stock - £1200 mn of the 8 1/2% issue and £1554 mn of the 9% issue - are such that a further tranche of £800 -1000 mn would help considerably to establish the chosen stock as a much needed current - coupon runner in that area.

8 Our proposal therefore is that we should announce on Friday 8 July that the next auction will be held on Wednesday 10 August and will be a medium-dated (7-15 years' maturity) stock.

Bank of England
June 1988

0304J/edh

LIKELY DATES OF MAIN STATSISTICAL EVENTS

UK

July

	1	
Mon	4	Reserves; Retail Sales (final); Credit Business
	5	
W	6	
	7	
	8	US Unemployment/Employment
Mon	11	Producer prices
	12	
W	13	
	14	Wages, Unemployment; Production Industries' Output
	15	Retail Prices; US Trade figures; US Producer Prices
Mon	18	Retail Sales (prov); PSBR; call on 2% IG 1994
	19	
W	20	Money figures
	21	US Consumer Prices
	22	Consumption (provsional)
Mon	25	
	26	CBI Quarterly Trends
W	27	Trade figures; US GNP (preliminary)
	28	US Personal Income and Consumption
	29	

August

Mon	1	
	2	Reserves; US Leading Indicators
W	3	
	4	
	5	US Unemployment/Employment
Mon	8	Retail Sales (final); Credit Business; Producer Prices
	9	US 3 year bond auction
W	10	US 10 year bond auction
	11	US 30 year bond auction (may not be held)
	12	US Producer prices
Mon	15	Retail Sales (prov); Production Industries' Output
	16	PSBR; US Trade figures
W	17	
	18	Money figures; Wages, Unemployment
	19	Retail Prices
Mon	22	US Consumer Prices
	23	GDP(O) provisional
W	24	
	25	Trade figures; US GNP (1st revision)
	26	US Personal Income and Consumption
Mon	29	Bank Holiday
	30	CBI Monthly Trends; US Leading Indicators; BP call
W	31	

INFLUENCES ON CASH FLOWS BETWEEN NOW AND END AUGUST

Redemptions

Date	Stock	Amount (£ million)
14 June	9 3/4% Tsy Conv 1988	1147
1 July	3% Trans 1978/88	1302

Calls

Date	Stock	Amount (£ million)
18 July	2% Index-Linked 1994	Upto 220

Gilt Dividends

Date	Amount (£ million)
June 1988 O/W second half	380 (0)
July 1988 O/W second half	1770 (1140)
August 1988 O/W second half	990 (700)

Privatisation

Date		Amount (£ million)
30 August	BPII	2130 (excludes official holdings)

psl/60A

CONFIDENTIAL

FROM: A C S ALLAN
DATE: 30 June 1988

SIR G LITTLER

cc Sir P Middleton
Mr Scholar
Mrs Lomax
Mr Peretz
Mr Ilett

TOKYO STOCK EXCHANGE AND GEMMs

The Chancellor discussed this with the Prime Minister at his bilateral last night. The Prime Minister agreed that the Bank should now let Nomura (and Daiwa in due course) go ahead as GEMMs. She would want to write to Takeshita at the same time as the announcement was made, and No.10 have asked for a draft. I attach a first shot, based on the line I understand was discussed yesterday, and would be grateful for any comments.

2. The Chancellor would be grateful for advice on when the announcement should be made.

ACSA

A C S ALLAN

psl/61A

DRAFT LETTER FROM THE PRIME MINISTER TO MR TAKESHITA

[Introduction]

[When you visited Londin in May] I explained to you the difficulties we faced because the London financial markets are so open and ready to admit overseas firms - including Japanese firms - in contrast to Tokyo, where there are considerable obstacles in the way of British firms setting up business.

2. You will now have seen that the Bank of England has recently given approval to Nomura Securities to start up in London as a Gilt Edge Market Maker [from 1 August], thus further demonstrating the generousness of our market arrangements for foreign firms. I hope that, following this, you will ensure that early progress is made on the question of further securities licenses on the Tokyo Stock Exchange, [on the lines we discussed in Toronto].

mjd 1/198A

CONFIDENTIAL

BF 4/7

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

30 June 1988

Paul Gray, Esq
No.10 Downing Street
London SW1

Dear Paul,

TOKYO STOCK EXCHANGE AND GEMMs

You told me that the Prime Minister had agreed that Nomura (and afterwards Diawa) should now be told they will be allowed to open for business as gilt edge market makers. You said the Prime Minister would want to write to Mr Takeshita at the time the announcement was made.

... I attach a first shot at a draft letter. I should be grateful for any comments you and Charles Powell have.

Yours
Alex

A C S ALLAN
Principal Private
Secretary

CONFIDENTIAL

DRAFT LETTER FROM THE PRIME MINISTER TO MR TAKESHITA

When you visited London in May, I explained to you the difficulties we faced in justifying the way in which London financial markets are so open and ready to admit overseas firms - including Japanese firms - whereas there are considerable obstacles in the way of British firms setting up business in Tokyo.

2. Nevertheless, you will now have seen that the Bank of England has recently given approval to Nomura Securities to start up in London as a Gilt Edge Market Maker [from 1 August], thus further demonstrating the generousness of our market arrangements for foreign firms. I hope that, following this, you will ensure that early progress is made on the question of further securities licenses for British firms on the Tokyo Stock Exchange, a matter which you told me you were taking a close interest in.

Content with this procedure; but button must not be pushed until PM's draft letter OK: At present it's not quite right: got Paul to look at it. N.

CONFIDENTIAL

From: Sir G.Littler
Date: 30 June 1988

MR ALEX ALLAN

c.c. Sir P.Middleton
Mr Scholar
Mrs Lomax
Mr Peretz
Mr Ilett

TOKYO STOCK EXCHANGE AND GEMMS

Thank you for your minute of earlier this morning.

2. I think we should work for action Tuesday or Wednesday of next week - which will give us time to get various simultaneous moves into shape. We shall need:

- Eddie George to contact Nomura (and afterwards Daiwa);
- P.M. message to Takeshita to be delivered;
- covering explanation to H M Ambassador (through whom I assume the message to Takeshita will be transmitted);
- co-ordination of press line in B/E, DTI and Treasury;
- B/E (I think) to tell BZW what we are doing;
- ? Lord Beaverbrook to write to Jock Bruce-Gardyne as a courtesy.

3. I cannot speak to Eddie George until later today. I have talked with Brian Willott of DTI. Work on the points above is in hand and I will let you have comments on the draft P.M. piece by close of play.

(Geoffrey Littler)

PERSONAL AND CONFIDENTIAL

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

4 July 1988

Dear Alex,

TOKYO STOCK EXCHANGE AND GEMMs

The Prime Minister has now signed a letter to Mr. Takeshita along the lines of the draft you kindly provided. I enclose a copy.

I should be grateful if you could now consider the timing for the Bank's action and advise us on the appropriate date for transmitting the letter.

CH/EXCHEQUER
REC. - 4 JUL 1988
ACTION Sir G. LITTLER
COPIES TO Mrs LOMAX
Mr ILETT

4/7

Yours,
Paul

(PAUL GRAY)

Alex Allan, Esq.,
HM Treasury.

PERSONAL AND CONFIDENTIAL

NOT YET TRANSMITTED

10 DOWNING STREET

LONDON SW1A 2AA

THE PRIME MINISTER

Dear Prime Minister,

When you visited London in May, I explained to you the difficulties we faced in justifying the way in which London financial markets are so open and ready to admit overseas firms - including Japanese firms - whereas there are considerable obstacles for British firms wishing to set up business in Tokyo. You told me you were taking a close interest in these matters.

You may now have seen that the Bank of England has today given approval to Nomura Securities to start up in London as a Gilt Edge Market Maker. This further demonstrates the openness of our market arrangements for foreign firms. I hope that I can now rely on you to ensure that early progress is made on the question of further ~~securities licenses~~ seats for British firms on the Tokyo Stock Exchange.

Yours sincerely

Margaret Thatcher

His Excellency Mr. Noboru Takeshita

35A/G/PC/3739/33

CONFIDENTIAL

FROM: N J ILETT
DATE: 4 July 1988

CHANCELLOR

Ch/ Content?
AS 4/7

c c Economic Secretary
Sir P Middleton
Sir G Littler
Mr Lankester
Mr Scholar
Mr H P Evans
Mrs Lomax
Mr Peretz
Mr Gieve
Mr Bush
Mr Sharples

Mr Hyett T.Sol

TOKYO STOCK EXCHANGE AND GEMMS

Further to Sir Geoffrey Littler's submission of 30 June, I attach:-

a. Draft Press Office briefing, for use by Treasury, DTI and Bank Press Offices;

b. A draft telegram to the Embassy in Tokyo to cover the Prime Minister's message to Mr Takeshita (your Office has a copy of the message as she has signed it);

c. A draft letter for Lord Beaverbrook to send to Lord Bruce-Gardyne, following Lord Bruce-Gardyne's two House of Lords PQs.

2. The briefing has been cleared with the Treasury Solicitor and the DTI. The Bank may have some comments overnight.

3. The press briefing is low-key. Obviously, it would be wrong to suggest that GEMM membership has been delayed at the Government's request or to comment about suggestions that further Japanese applications might be delayed in future. On the other hand, if we do not go out and push the story that the Japanese

will have got the point, and that further opportunities for reinforcing the point will occur, there is some risk that the UK press will think we have backed down. I have discussed with Sir Geoffrey Littler and the Press Office whether, on balance, it is worth trying to place more positive unattributable material with selected journalists; IDT's firm view is that this would be a high-risk strategy which they do not recommend.

4. Mr George is arranging to see Nomura tomorrow afternoon, Tuesday. If Nomura fix on a date for starting then, he will call Daiwa in immediately and invite them to start one month later. If, however, Nomura want to reflect on their chosen starting date, Mr George will call Daiwa in on Wednesday.

5. The briefing therefore needs to go to Press Offices towards the end of the morning tomorrow, and the telegrams ought to go to Tokyo tomorrow afternoon in time for the opening of business on Wednesday, Japanese time.

6. I am sending copies of this submission to Mr E A J George (Bank of England) and to Mr W B Willott (DTI).

M.

N J ILETT

G42a/PC/3739/029

CONFIDENTIAL

DRAFT TELEGRAM

TO: IMMEDIATE TOKYO

Copy Governor Hong Kong

DRAFT

TOKYO STOCK EXCHANGE MEMBERSHIP AND GEMM STATUS

It has been agreed that the Bank of England should now tell Nomura and Daiwa that they will be allowed to start gilt edged market making operations shortly. The Bank are seeing Nomura today, London time; and Daiwa either immediately thereafter or as soon as Nomura have decided when to start trading. (The Bank will suggest Nomura should start on 1 August, but this may slip if Nomura want more time. Daiwa will be invited to start one month later.)

2. The Prime Minister has decided to send Mr Takeshita a message - text in MIFT. Please transmit this to his office. Original follows by bag.

3. This decision follows very careful consideration of the difficult issues involved. As you know, we have avoided making an indefinite link between

GEMM status and the outstanding applications by British houses for seats on the Tokyo Stock Exchange. It has become evident that there is no realistic prospect of the Japanese delivering an immediate TSE seat for BZW, and the delay Nomura and Daiwa have experienced in starting gilts operations has registered our disappointment clearly and publicly. Further use of this particular tactic might begin to raise awkward legal questions and would in Ministers' view be against the interests of the gilts market, the City generally and the existing UK presence in Japanese financial markets.

4. As you know, there will be other opportunities to make our point with the Japanese over the coming months if there is no early progress on the TSE. We shall continue to register concern with the Japanese whenever appropriate (the Chancellor spoke firmly, on usual lines, to Mr Miyazawa in Toronto about TSE membership though the Prime Minister had no (no) bilateral with Mr Takeshita).

5. BZW are being assured that our commitment to their support is undiminished.

6. We propose to take a low-key approach to press enquiries. It will be for Nomura and Daiwa to announce their starting dates, which we expect them to do more or less immediately. The Bank will, when asked, confirm these dates to the press.

Treasury and DTI press offices will say that the Bank's decision confirms our policy of welcoming foreign institutions to London, and will emphasise our insistence that the Japanese should admit qualified UK applicants to the TSE and, generally, offer the same access to their markets as we offer in ours. But they will not suggest that the delay beyond the original date in admitting Nomura and Daiwa was related to specific UK disappointments in Tokyo and, if asked, will deny that it was ever the intention to hold back GEMM status until Tokyo Stock Exchange seats were granted.

ENDS

TOKYO STOCK EXCHANGE/GEMMs : PRESS BRIEFING

LINE TO TAKE

Bank Press Office (ONLY)

Confirm that Nomura and Daiwa have been invited to start trading on the [precise dates to be negotiated]. [Bank Press Office to liaise with Treasury and DTI when dates are known.]

Treasury/DTI Press Offices

It is for the Bank to confirm if and when firms become gilt edged market makers. But we are aware that the Bank has invited Nomura and Daiwa to start trading on these dates.

All Press Offices

i. The admission of Nomura and Daiwa to GEMM status is further proof of the openness of London markets. We expect other international financial centres to show the same openness to UK institutions.

ii. While the Japanese have made progress in opening up markets, some UK applications are still outstanding in Tokyo; over time, further UK houses will want to enter Japanese markets, just as more Japanese houses will be very keen to set up in this country. We hope to give these Japanese houses the welcome we would like to see the Japanese giving to UK houses in Tokyo.

Defensive : for use only if pressed

UK has given in to Japan

Japanese markets are much more open than they used to be; UK houses have obtained securities branch licences and investment management licenses in significant numbers, and four Tokyo Stock Exchange seats in the last round. This reflects consistent pressure we have exercised on the Japanese authorities.

BZW still have no TSE seat

UK authorities have made their views plain to the Japanese but it has never been suggested that Japanese houses would only be admitted to the gilts market when particular UK houses had been admitted to Tokyo. (N.B. no mention of particular names.) Quite sure that the Japanese understand that we are serious in our determination to support UK houses' ambitions in Tokyo. Ministers press this point on their Japanese counterparts whenever they meet.

Why the delay?

As Lord Beaverbrook said in the House of Lords on 25 May the reason why Nomura and Daiwa did not start trading earlier is that a number of issues were under consideration. It is not the practice to comment in detail on applications of this kind by financial institutions.

Use Financial Services Act reciprocity powers?

No question of using Financial Services Act reciprocity powers on this occasion. We hope never to have to use them. But they would be used if that became necessary.

42A/G/PC/3739/32

DRAFT LETTER FROM:

Lord Beaverbrook
Department of Trade & Industry

TO:

Lord Bruce-Gardyne
House of Lords

As you have raised the question of the applications by Nomura and Daiwa to make markets in gilts in the House recently, I thought I should let you know that I understand that the Bank of England have today indicated to these two firms that they will be welcome to start trading shortly. The Bank will be confirming this news, if asked; but in accordance with the usual practice on these occasions, it is for the two firms themselves to decide how and when to make the news public.

BEAVERBROOK

mjd 2/167Jn

CONFIDENTIAL

FROM: J M G TAYLOR

DATE: 5 July 1988

MR ILETT

cc PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr Lankaster
Mr Scholar
Mr H P Evans
Mrs Lomax
Mr Peretz
Mr Gieve
Mr Bush
Mr Sharples

Mr Hyett T/Sol

TOKYO STOCK EXCHANGE AND GEMMS

The Chancellor has seen your submission of 4 July. He is content with the press briefing, the draft telegram to the Embassy in Tokyo, and the draft letter for Lord Beaverbrook.

2. There was an error in the letter from the Prime Minister to Mr Takeshita: the last sentence should read "...further seats for British firms on the Tokyo Stock Exchange." I have passed this on to Mr Gray, who will resubmit the letter to the Prime Minister this evening.

J M G TAYLOR

G42a/CD/3740/003

CONFIDENTIAL

FROM: N J ILETT
DATE: 5 July 1988

PS/CHANCELLOR

TOKYO EXCHANGE/GEMMS
LETTER FROM LORD BEAVERBROOK TO LORD BRUCE-GARDYNE

As Lord Beaverbrook's exchange with Lord Bruce-Gardyne was in Lord Beaverbrook's capacity as a Treasury spokesman, rather than a DTI spokesman, we need to advise him to write to Lord Bruce-Gardyne about today's events. I attach a draft letter, which is of course drafted on the assumption that the Chancellor has opproved the submission I put up last night.

M.

N J ILETT

G42a/CD/3740/003

Cfl.

~~DRAFT~~ LETTER

Nick Mitchell, Esq

To: ~~Private Secretary~~
Lord Beaverbrook
Department of Trade and Industry

GILT EDGED MARKET MAKERS

The Bank of England is today inviting Nomura and Daiwa to start making markets in gilts. As Lord Beaverbrook has answered two questions from Lord Bruce-Gardyne on this subject recently, the Chancellor thought that Lord Beaverbrook might like to write briefly to Lord Bruce-Gardyne to give him this news. I attach a draft.

AMG TAYLOR
(PRIVATE SECRETARY)

mjd 2/168Jn

Treasury Chambers, Parliament Street, SW1P 3AG
01 270 3000

5 July 1988

cc: Mr Tlett

Nick Mitchell, Esq
Private Secretary/
Lord Beaverbrook
Department of Trade and Industry
1 Victoria Street
London SW1

Dear Nick

GILT EDGED MARKET MAKERS

The Bank of England is today inviting Nomura and Daiwa to start making markets in gilts. As Lord Beaverbrook has answered two questions from Lord Bruce-Gardyne on this subject recently, the Chancellor thought that Lord Beaverbrook might like to write ... briefly to Lord Bruce-Gardyne to give him this news. I attach a draft.

Yours sincerely

Jonathan Taylor

J M G TAYLOR
Private Secretary

DRAFT LETTER FROM:

Lord Beaverbrook
Department of Trade & Industry

TO:

Lord Bruce-Gardyne
House of Lords

As you have raised the question of the applications by Nomura and Daiwa to make markets in gilts in the House recently, I thought I should let you know that I understand that the Bank of England have today indicated to these two firms that they will be welcome to start trading shortly. The Bank will be confirming this news, if asked; but in accordance with the usual practice on these occasions, it is for the two firms themselves to decide how and when to make the news public.

BEAVERBROOK

ECONOMIC SECRETARY TO THE TREASURY

PPS

You will want to be aware that the Bank will be announcing an auction of short gilts tomorrow. The decision was taken at the funding meeting earlier this week.

PR 7/7

SECRET

Ry

CILT-EDGED AUCTION

The Bank of England announces that an auction of gilt-edged stock will be held on Wednesday, 10 August 1988. The auction will be of a short-dated stock (up to seven years to maturity).

Details of the amount and specific stock to be auctioned and of the te.ms of the auction will be announced at 3.30 pm on Tuesday, 2 August 1988, at which time dealings in the new stock on a 'when issued' basis may commence. The SEDOL code to be used is 0-998-214. The EPIC code AUC should be used for trade reporting purposes.

8 July 1988

PS/EST

We spoke. The proposed press notice above looks absolutely fine to us. The announcement will be made tomorrow. The details (which will not be announced until 2 August) are £750m of 8½% Treasury 1994. This is a further tranche of the non-FOTRA stock originally issued just after the budget. No decisions yet on whether it will be full or part paid (but I imagine part paid). The Funding minutes (which will be round this afternoon) record the discussion & you should refer Alex to them. Cathy Ryding 7/7.

RESTRICTED

FROM: J P MCINTYRE
DATE: 18 July 1988

FINANCIAL SECRETARY

cc Chancellor
Chief Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mrs Lomax
Mr Peretz
Miss Peirson o.r.
Mr Culpin
Mr Ilett
Mr Gieve
Mr Macpherson
Mr Portes
Mr Cropper
Mr Lewis (IR)

NICS ON GILTS ETC

You may be interested to see the attached report which appeared in Friday's Evening Standard.

2. The article reports that Warburgs will pay annual bonuses to senior employees in units of unit trusts rather than cash, because the units will be exempt from NICs. (This will of course be of direct advantage to Warburgs, in reducing their bill for employers NICs, rather than their senior employees who are no doubt paid more than the Upper Earnings Limit.)

3. You will remember that, at our instigation, the DHSS introduced new regulations in May making payments in the form of gilts and other debt instruments subject to NICs. DHSS Ministers, with your agreement, made it clear at the time that if evidence emerged of employers using other securities to evade NICs, the government would take further action.

4. So far, DHSS say they have no other evidence of firms switching from gilts to equities or unit trusts in order to avoid the new restrictions (or, as with Warburgs, switching from cash to equities or unit trusts.) However, it is early days, and this is obviously something they will be keeping an eye on.

JM

J P MCINTYRE

share price—halted at 470p—would nosedive when the shares ended their two-

Bonus surprise at Warburgs

by Peter Oborne

EMPLOYEES of SG Warburg have been told that their annual bonus will be paid in the form of units of selected unit trusts managed by Mercury Asset Management rather than in cash.

The scheme will encompass all employees on the senior bonus scheme, some of whom were dismayed by the move. But group personnel director Hugh Stevenson explains: "Benefits in kind are exempt from National Insurance. Units in Mercury will be treated as kind."

Value

In previous years Warburg has paid its bonuses in cash. However it has been fairly common in the City to pay bonuses in the shape of gilts. [illegible]

● Standard 50 Shares—Page 63

Kuwait call to arms

Associated Newspapers

INTERIM RESULTS FOR THE HALF-YEAR 31st MARCH 198[illegible]

(Unaudited)

Turnover

Profit before Exceptional Items

Exceptional Profit

Redundancy and Development

Profit before taxation

Earnings

Dividend

Some broking housing like Chase Manhattan were say

Rover deal ran into tro with the European Com

42/2/cag/48/2157 **RESTRICTED**

FROM: **R C M SATCHWELL**

DATE: **19 July 1988**

MR McINTYRE

I would like to be consulted before any action is taken

cc PS/Chancellor
PS/Chief Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mrs Lomax
Mr Peretz
Miss Peirson
Mr Culpin
Mr Ilett
Mr Gieve
Mr Macpherson
Mr Portes
Mr Cropper
Mr Lewis (IR)

NICS ON GILTS ETC

The Financial Secretary was most grateful for your minute of 18 July. He has commented: "Any more evidence and I think we should probably act."

R.C.M.S.

R C M SATCHWELL
Private Secretary

NH8/83Jo

RESTRICTED

FROM: J M G TAYLOR
DATE: 21 July 1988

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mrs Lomax
Mr Peretz
Miss Peirson
Mr Culpin
Mr Ilett
Mr Gieve
Mr Macpherson
Mr Portes
Mr Cropper
Mr Lewis IR

NICS ON GILTS ETC

The Chancellor has seen your minute of 19 July. He has commented that he would like to be consulted before any action is taken.

J M G TAYLOR

mg.ee/dlcp/2.11.8

SECRET

Would you like us to discuss this further with the Bank? Because of the uncertainties in the funding arithmetic there is much to be said for leaving a decision as late in the financial year as possible. If we were to use the existing technique (see para 2) there would be no need for any high profile prior announcement, and a final decision could be left until February or March — though we will need to decide before Christmas whether or not to proceed with the second "normal" auction.

FROM: CATHY RYDING
DATE: 12 August 1988

1. MR PERETZ
2. ECONOMIC SECRETARY

cc PPS
Mr Scholar or
Mr Grice or
Miss O'Mara or
Mr Tyrie or

REVERSE GILT-EDGED AUCTION

Alex Allen, in his minute to your Private Secretary of 11 July, asked for advice on whether it would be possible to hold a "reverse auction", with a view to announcing the first such auction in the Autumn Statement. You subsequently asked (in your Private Secretary's minute of 12 July), for the advice to cover both the mechanics and the presentation. This minute contains provisional Treasury advice, which we have not yet discussed with the Bank. If you are keen to investigate this further, we will obviously need to do so.

Techniques

2. A mechanism already exists by which the Bank can, at its own initiative, buy in large quantities of stock in what amounts to a mini "reverse auction". This mechanism is described in the Bank document of September 1986 on the future structure of the gilt-edged market (relevant section attached). The mechanism has never in fact been used, although the Bank proposed it should be employed to support the gilt market on two occasions when the market was very weak - first in November 1986 and second in June 1987. On both occasions Treasury Ministers resisted the proposal - on the grounds that to use the mechanism (particularly for the first time) would give a "signal" in circumstances where we did not want to do so, and that the market should be capable of operating without such support. An agreed "code of practice" was subsequently drawn up (after much discussion) indicating the sort of circumstances in which it would be appropriate to consider a "reverse auction". This notes that the mechanism could be used

for operations other than those designed to support the market at a moment of weakness: for example it could be used to avoid an overfund.

3. Alternatively an entirely new procedure could be designed and announced. The existing mechanism is obviously designed for market support. If the buying-in is being done for debt management reasons it would probably, for example, be sensible to give much more notice than envisaged in paragraph 27(i) of the 1986 paper.

4. In either case there is an important difference between an auction and a "reverse auction". The former is for a single stock, which makes it easy to allot on the basis of bids. In the latter case, the offer to buy would sensibly extend to at least range of stocks within the chosen maturity band - for if it were confined to only one stock it would be likely to raise its price relative to the rest of the market. But if a range of stocks is taken it could be difficult to devise a simple rule for deciding which tenders were lowest. You will see that the existing technique leaves this to the Bank's discretion, and also leaves scope for the Bank to vary the quantity bought depending on the price at which it is tendered.

Presentation

5. A "reverse auction" would attract a considerably higher profile than the Bank's usual buying in operations - partly because of its novelty and partly because of the amount of stock involved (probably not less than £100 million). We have been considering for a while whether a public statement of the Bank's willingness to buy-in (which is what an auction would amount to) would be helpful - you may recall that BZW suggested this to you in April. The main advantage of such a statement would be to demonstrate the Government's determination and commitment to defeat inflation and to bring down yields over the longer term. However, the procedure would also raise a number of difficulties, not least that our funding needs could change unexpectedly (perhaps as last year because of positive intervention), or long

yields could fall, relative to short yields, to the point where we wished to reverse our position (which would then have to be done in an equally high profile way).

6. We did discuss the possibility of a public statement with the Bank at the April funding meeting. But they were far from keen. Throughout the buying-in operation to date they have been concerned that their activities should remain as unobtrusive as possible, mainly because they have not wanted to be seen as providing a floor to the market or risk driving prices against themselves. One worry (which we to some extent share) is that if overseas purchasers perceive an official floor to the market, they will be keen to buy gilts and so put upward pressure on the exchange rate. The Bank's other worry has been that high profile buying-in would force prices up and yields down to such an extent that buying in longs is no longer our preferred strategy. We see this as a benefit rather than a loss, but it is an extra argument for not setting a precise quantity to be bought in advance.

Reverse auction vs ad hoc buying in

7. The funding arithmetic is uncertain, but on the figures circulated for the July funding meeting (and taking account of net sales since then), and ignoring the possible conventional auction in January/February and the implications of the FRN, implies buying in of £0.5 billion to square the books. At their current rate of progress, the Bank could almost certainly manage to buy-in this quantity of longs over the rest of the year unless market conditions change dramatically. Our guess is that they would make heavy weather of anything much more and we would have difficulty holding the line that the purchases must be of longs.

8. If, therefore, it appears that we shall need to buy in much more than currently anticipated, we will almost certainly have to consider some kind of "reverse auction" type operation, on the assumption that we are not prepared simply to allow the Bank to buy in across the maturity structure. While the "reverse auction" would make the authorities' intentions explicit, it would be

difficult to disguise them in any case once we bought in on a really large scale.

9. The argument against a reverse auction is that we would have little room for manoeuvre over timing and so would be less able to take advantage of market circumstances than with normal buying in. Ideally, the best time to buy in is when yields are at a peak. Obviously, it is impossible to know with any degree of certainty when yields have peaked, but it is probably better, as well as easier, to buy in a falling market (ie rising yields) than in a rising one.

Timing

10. If we want to announce a "reverse auction" at the time of the Autumn Statement, the Government's improved financial position would then be public knowledge and this would make presentation easier. Even so, the funding position could still change significantly in the following 4 months to the end of the financial year. And we would presumably need to announce at the same time that there would not be a second "normal" auction this year. Normally, given all the uncertainties in the funding arithmetic we would not want to take either decision until shortly before Christmas.

Conclusion

11. The way the funding arithmetic looks at the moment, we are less likely to need a "reverse auction" just to square the books than we would have thought a few weeks ago. But the numbers could still change in such a way that we would need to buy in significantly, and we might still want to buy-in longs simply as part of our restructuring exercise. While the advantages of a reverse auction are not clear cut, we have already indicated publicly (in the Bank's 1986 paper) that we would be prepared to consider the possibility. If as we suspect the Bank will oppose the idea it probably makes sense to hold off consulting them until the funding position is rather clearer. If we wished to announce it at the time of the Autumn Statement we would need to discuss it

with the Bank at the end September funding meeting. But given the funding uncertainties and the need to make an announcement at the same time about the second "normal" auction it might be better to wait until later in the year before making a decision.

Cathy Ryding

CATHY RYDING

Extract from: The Future Structure of the Gilt-Edged Market: Official Operations

27. Similar arrangements will apply to such *outright purchases* of stock as the Bank may wish to undertake on its own initiative.

(i) In the (probably rare) case where we wished to provide substantial market support, say, of £100 million or more we would make a public announcement (on screens) inviting market makers to submit offers of stock. Such an announcement would normally be made at 4.30 p.m. for offers to be submitted at 4.40 p.m. Acceptance would be at the Bank's discretion, but we would normally expect to take the cheapest offers. Scaling down in proportion to the amounts offered would be undertaken if necessary. The Bank would respond to such offers as soon as possible, and in any event by 5.00 p.m. No further announcement would be made unless the scale of support provided was materially different from that suggested in the 4.30 p.m. announcement.

(ii) Where we wished to buy only smaller amounts we would do so in direct dealings with individual market makers.

28. At the same time, as indicated in paragraph 13 (iii)-(v) of the blue paper, in response to a market maker's initiative, the Bank will also be prepared —

(a) to bid a price of its own choosing for stock with three months or less maturity offered to it by market makers;

(b) to bid a price of its own choosing for index-linked stock offered to it by market makers; and

(c) at its discretion to purchase outright, at prices of its own choosing, other stock that may be offered to it by market makers. The Bank expects to exercise this discretion more liberally for stocks with between three and twelve months to maturity than for other stocks.

These operations would only be carried out through direct dealings with individual market makers. In the case of (a) the Bank expects to publish its buying price continuously. In the case of (b) and (c) the Bank will expect to be approached by a market maker only where the transaction could not readily be carried out in the market and will expect normally to bid somewhat below the price prevailing in the market, with the extent of the discount on the market price depending upon the amount of stock offered and upon where we stood in relation to the funding programme.

29. The Bank will be prepared to consider proposals for switches from individual market makers. We will normally be prepared to undertake a switch at prevailing market prices, in order to assist market liquidity, if we are in a position to do so (which often of course we will not be), though the Bank will normally expect to be a net seller of stock when undertaking switches. Where a switch involves official funds not under the Bank's direct control it may take some time to arrange, and the terms will depend on the needs of the funds involved. For the particular arrangements applying to switches into taps or tranchettes see paragraph 19.

30. Finally, the Bank's dealers will have discretion to undertake very small-scale "sampling" transactions directly with the market makers.

Bank of England
18 September 1986.

SECRET

FROM: A C S ALLAN
DATE: 11 July 1988

PS/ECONOMIC SECRETARY

cc Mr Scholar
Mr Peretz o/r
Mr Grice
Miss O'Mara
Mrs Ryding
Mr Tyrie

FUNDING

The Chancellor has seen the minutes of the Economic Secretary's funding meeting on 4 July.

2. He is very attracted to the idea of a "reverse auction", canvessed in paragraph 6 of Mr Wheatley's minutes. He would be grateful for further advice on this, with a view to announcing the first such auction in the Autumn Statement.

ACSA

A C S ALLAN

53/2/LPD/3757/051

SECRET

ECONOMIC SECRETARY TO THE TREASURY

FROM: P D P BARNES
DATE: 12 July 1988

MISS O'MARA

cc Mr Scholar
Mr Peretz
Mr Grice
Mrs Ryding
Mr Tyrie

REVERSE AUCTION

The Economic Secretary has seen Mr A C S Allen's minute to me of 11 July.

2. The Economic Secretary would be grateful if the note on this subject could cover both the mechanics and the presentation of a reverse auction.

PB

P D P BARNES
Private Secretary

SECRET

FROM: S M A JAMES

DATE: 16 August 1988

MRS RYDING

cc PS/Chancellor
Mr Scholar o/r
Mr Peretz
Mr Grice o/r
Miss O'Mara o/r
Mr Tyrie

While I am content with X, it is <u>essential</u> that discussion with the Bank is not delayed to a point that would preclude announcement of this in the AS.

REVERSE GILT EDGED AUCTION

The Economic Secretary was grateful for your submission of 12 August.

2. The Economic Secretary would like a meeting in early September to discuss the issues. He does not wish officials to discuss this further with the Bank at this stage.

X

3. The Economic Secretary would like officials to give more thought to the mechanics of an auction. He agrees there is a problem with the submission of different stocks; we cannot limit a reverse auction to one stock. The Economic Secretary wonders

i How the Bank would decide which stocks are cheap relative to the others?

ii How much could we hope to raise?

iii How much public notice would be required?

S M A JAMES
Private Secretary

chex.ps/mw/18 **SECRET** BF to AGSA 5/9

FROM: MISS M P WALLACE
DATE: 23 August 1988

PS/ECONOMIC SECRETARY

cc Mr Scholar
Mr Peretz
Mr Grice
Miss O'Mara
Mrs Ryding
Mr Tyrie

REVERESE GILT EDGED AUCTION

The Chancellor has seen Mrs Ryding's minute of 12 August and yours of 16 August. He has commented that, although he is content for discussion with the Bank to be delayed until after the Economic Secretary's meeting, it is essential that it is not delayed to a point that would preclude announcing this in the Autumn Statement.

MPW.

MOIRA WALLACE

mg.ee/dlcp/1.9-rgea

SECRET

From : D L C Peretz
Date : 1 September 1988

ECONOMIC SECRETARY

cc PS/Chancellor
Mr Scholar
Mr Grice
Miss O'Mara o/r
Mrs Ryding
Mr Tyrie

REVERSE GILT-EDGED AUCTION

I attach a minute from Mrs Ryding answering the questions in your Private Secretary's minute of 16 August.

2. It may help to illustrate the points in relation to three possible types of "reverse auctions".

i) An offer for a fixed amount (say £½ billion) of stock.

ii) An offer for an unspecified amount, but at a specified price.

iii) An offer for an amount unspecified both as to price and amount.

In each case we could of course state the particular type of stock we were interested in - say 15 years plus.

3. In the first case, there would be a risk, if potential sellers held back, of having to buy some rather expensive stock. And it is hard to see any alternative to leaving the Bank some discretion in deciding precisely which stocks to buy and which not to buy - though they would have to decide very quickly after tenders wre in. There would be a case for making an announcement of the details some time in advance, to allow potential sellers to emerge. On the other hand announcing a reverse auction in a particular maturity range might move the yield curve so far as to alter our own preference for maturity for buying in.

4. In the second case, we would need to specify particular prices for particular stocks. We would then be open on the one hand to the risk that if the whole market fell between the time of announcement and the reverse auction we could be left holding a very large volume of stock; and on the other, if the market rose (perhaps as a result of the announcement) we might pick up nothing at all.

5. The third option avoids some of these potential problems. On the other hand it is the procedure least like a "auction"; and indeed not necessarily very different from a publicised version of the Bank's day by day discretionary buying in activities.

DLP

D L C PERETZ

mg.ld/Ryding/(1)22.8min

SECRET

FROM: CATHY RYDING

DATE: 1 September 1988

MP

1. MR PERETZ
2. ECONOMIC SECRETARY

cc PS/Chancellor
Mr Scholar o/r
Mr Grice o/r
Miss O'Mara o/r
Mr Tyrie

REVERSE GILT EDGED AUCTION

Your private secretary's minute of 16 August raised a number of further questions on reverse auctions.

2. You asked how the Bank would decide which stocks are cheap relative to others. As I said in my minute of 12 August, this will not be an easy decision. Generally speaking, the Bank would compare the yield offered for any stock with that prevailing in the market at the time for the same stock and for the closest analogous stocks, in much the same way as they do at present when tapping out stock into the market. This leaves the difficulty of ranking the different stocks offered to the Bank against each other, particularly where we have preferences of our own about for example, the maturity of buying in. The existing procedure allows the Bank a degree of discretion, and this may be inevitable.

3. You also asked how much stock we could hope to buy in using this procedure. This will of course depend in the first instance on how much we are prepared to pay for the various stocks, but how much we <u>want</u> to buy in will also depend on other factors such as how many longs we have already managed to buy in, and our assessment of the overall funding position. It may be, for example, that many of the remaining holders of longs are insurance companies and pension funds who are natural holders of longs and will only part with them at a high cost to us. Also an offer to buy in only longs would make our policy very clear and some holders might decide to hold off selling for the time being until longs become scarcer when they will get a better price for them.

4. Our preliminary view is that given all the uncertainties it would be sensible to go for a pretty modest amount, first time round at least, say £100m - £500m.

5. Finally, you asked how much public notice will be required. As you will see from my earlier submission, the 1986 paper envisaged a buying-in announcement being made at 4.30 pm for offers to be submitted at 4.40 pm. A reverse auction of the type we are now considering is however rather different from the market support mechanism envisaged in the 1986 paper, and we would be expected to give longer notice. Clearly we would have to do so if the Chancellor wished to make an announcement in the Autumn Statement, though that could be in very general terms.

6. As to announcement of the details, the argument for giving more notice is that it will give potential sellers time to emerge. The argument for giving very short notice is that market circumstances could change dramatically between announcement and the auction itself.

Cathy Ryding

CATHY RYDING

est.ld/secret/sec002

SECRET

FROM: ECONOMIC SECRETARY
DATE: 14 September 1988

CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz
Mr Grice
Miss O'Mara
Mr Wheatley
Mr Tyrie

Ch/
content?

npw 15/9

REVERSE GILT-EDGED AUCTION

You asked (Mr Allan's minute of 11 July) in the light of the current funding position, for advice on the possibility of holding a "reverse auction" with a view to an announcement in the Autumn Statement. I have now had an opportunity to discuss the mechanics of doing so with officials, on the basis of Mrs Ryding's minute of 12 August and Mr Peretz' minute of 1 September.

Case for a reverse auction

2. On the latest funding arithmetic, we shall need to buy in around £1.7 billion over the remainder of the financial year. These figures are based on a PSDR forecast of £9.5 billion, a further £1 billion auction and no reversal over the rest of the year of the £2 billion intervention carried out so far. However, the PSDR could turn out to be larger or we might need to unwind some or all of the intervention we have already undertaken so increasing the amount of gilts we needed to buy in. To date, the Bank have succeeded in buying-in around £1 billion, not all at the long end. In order to meet our target, we may well need to step up our purchases of long gilts and I believe a reverse auction could have a useful role to play here.

Type of auction

3. Of the three types of reverse auction identified by Mr Peretz, I believe we should make an offer for a fixed amount of stock. However, in order to ensure we are not forced to buy stock at excessively high prices, I believe we should set a maximum figure and announce our intention to buy "up to" that. While our intention would be to make the maximum purchase, the presumption could be a good deal weaker than the presumption at normal auctions that we will allot stock in full. There seems less advantage to be had from tying our hands in the same way.

Scale of auction

4. I agree it is sensible to proceed fairly cautiously and would not want to announce an initial reverse auction of more than £½ billion. However, in initial discussions with the Bank, I suggest we should talk in terms of a £1-½ billion range.

Presentation

5. I assume you will want to link the announcement of the first reverse auction with the revised forecast of the PSDR which you give in the Autumn Statement. I suggest you might say simply that, given the larger PSDR now in prospect, the authorities will be buying in stock from the market, and to extend the range of techniques available, the Bank will shortly be announcing the details of a reverse auction procedure. It would be helpful if we could indicate at the same time that we are deliberately buying-in at the long end and explain why, not least because this would emphasise our commitment to reducing inflation over the longer term, at a time when our new forecast will show a temporary upward blip in the rate. But I appreciate the pressures on the length of the Statement and, if necessary, we could reserve this point for our subsequent announcement. (This material would, indeed, fit more naturally into the Mansion House speech but we could not

announce we were considering the reverse auction concept in advance of the Autumn Statement, without raising questions about the revisions to our PSDR forecast.)

6. Given the uncertainties which will still surround the funding arithmetic at the time of the Autumn Statement, I have considered whether it would be more sensible to defer any announcement that we were considering a reverse auction until a later stage in the year. If sterling came under strong upward pressure in the next couple of months and the Bank were intervening heavily, thereby reducing the need to buy-in, we might wish to think again about whether to proceed. We also have to allow for the possibility of similar pressures emerging after the announcement. It is for that reason I suggest a form of words that does not commit us to holding a reverse auction this year, but simply to publishing details for a procedure. Given the future prospects for the PSDR, we can be reasonably confident of wishing to use the technique in future, even if we did not use it this financial year.

(!)

7. The Bank will certainly have views on the subject and I should like to put the proposal to them in a way that encourages them to approach it constructively. Are you content for officials to open discussions with them on this basis?

PETER LILLEY

chex.nh/mw/42

SECRET

1. APH (x) 2. [illegible]

FROM: MISS M P WALLACE
DATE: 16 September 1988

PS/ECONOMIC SECRETARY

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz
Mr Grice
Miss O'Mara
Mr Wheatley
Mr Tyrie

REVERSE GILT-EDGED AUCTION

The Chancellor was most grateful for the Economic Secretary's minute of 14 September.

2. He is content for discussions to be opened with the Bank on the case for an auction, and the form it might take, as set out in the Economic Secretary's paras 2-4. He thinks the discussions should also cover the question of what gilts we offer to buy: it may well be longs, but there is also a case for next maturities and, he adds, "even for War Loan!"

3. On the question of presentation, the Chancellor's view is that the announcement should clearly be made in the Autumn Statement, but he will wish to consider further (and nearer the time) precisely what should be said.

MPW.

MOIRA WALLACE

mg2.jw.mg1.rydingfund

covering SECRET

BF 30/9

FROM: CATHY RYDING
DATE: 23 September 1988

~~BF 27/9~~

ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Scholar
Mr Peretz
Miss O'Mara
Mr Grice
Mr Rich
Mrs Davies
Mr Tyrie

Mr Patterson) DNS
Mr Wilson)

Mr Plenderleith - B/E
Prof Griffiths - No 10

FUNDING MEETING

There are four items on the agenda for the meeting on Wednesday 28 September:

(i) Funding arithmetic

(ii) National Savings

(iii) Gilt Edged Funding *

(iv) Money Market Assistance - Stocktaking report

2. I attach papers on items (i)-(iii) together with a note on cost of funding. Item (iv) will be raised orally.

* to be circulated next week.

Cathy Ryding

CATHY RYDING

eog5.ay21.9cr

SECRET

FUNDING ARITHMETIC 1988-89

(Note by MG)

1. This note discusses the total funding requirement for the current financial year, based on an M4 funding rule.

2. The attached table shows the main elements of the arithmetic. The table assumes a PSBR surplus of £10 billion, the latest figure emerging from the Autumn forecasting round. The PSBR forecast is still very uncertain and it is worth remembering that the average error (over the last 10 years) on in-year forecasts made at the time of the Autumn Statement is £3bn either way at today's prices. Intervention so far this year has been positive and this is assumed to be offset during the remainder of the year. (This is broadly in line with the Autumn forecast.) The intervention assumption is uncertain, and implies negative intervention over the rest of the year of almost $3bn.

3. National savings are assumed to contribute £1.7 billion over the full year. This is a £700 million higher figure than we were assuming at the last funding meeting, and reflects DNS' revised forecast. CTDs are assumed to be run down by £750 million, a £250 million lower figure than was assumed at the last meeting.

4. The arithmetic assumes net sales by the bank and building society sector of £1.5 billion over the financial year as a whole, ie effectively no further sales or purchases for the remainder of the year. This is a particularly uncertain assumption that we will need to keep under review.

5. On these assumptions, the arithmetic implies gross gilt buying-in of £2.8bn for the year as a whole, with £3.5bn of buying-in to be achieved between September and March. Gilt sales so far in September total £0.1bn to close on Thursday, which implies £3.6bn buying-in over the remainder of the year, an average of £0.6bn per month, October to March. Any sales of the £0.4bn of IGs currently on the Bank's books and any further sales will increase the buying-in requirement.

TABLE 22

SECRET

FUNDING : FINANCIAL YEAR 1988/89 22/9/88

£ million

	FORECAST Financial Year 88/89	OUTTURN April - Aug 88	RESIDUAL Sept 88 - Mar 89	
PSBR AND FUNDING TARGET				
1 PSBR excl asset sales	-3800	289	-4089	
2 Asset sales (sales-)	-6200	-4927	-1273	
3 PSBR	-10000	-4638	-5362	
FINANCED BY:				
4 OPS debt sales to M4ps (sales-)	1000	500	500	
5 National Savings (sales-)	-1700	-638	-1062	* -152
6 CTDs sales to M4ps (sales-)	750	149	601	
7 Treasury bills etc M4ps (sales-)	0	65	-65	
8 Intervention (reserves inc+)	0	1669	-1669	
9 Public sector externals excl intervention and gilts (inc-)	0	92	-92	
10 NET GILT SALES TO M4PS & OVERSEAS NEEDED FOR FULL FUND (sales+)	-9950	-2801		
11 Adjustment for 1987/88 underfund	400			
12 OVER(-)/UNDER(+)FUNDING	-400	-1290	890	
GILT SALES:				
13 Net purchases by M4ps and overseas (purchases+)	-9550	-1511	-8039	
14 Net purchases by banks/b socs & other public sector (purchases+)	-1500	-1410	-90	
15 Maturities	8300	3699	4601	
16 GROSS OFFICIAL SALES	-2750	778	-3528	
17 Monthly average gross gilt sales	-229	156	-504	

* average per month

Relationship between lines:

3 = 1 + 2
10 = 3+4+5+6+7+8+9
12 = 10 + 11 - 13
16 = 13 + 14 + 15

CONFIDENTIAL

NATIONAL SAVINGS

(Note by MG1 Division)

This note reports the latest position on National Savings and comments on prospects for the period to end-November 1988. A table on funding in the current financial year and likely results to the end of November is attached.

Results for August 1988

2. There was a total net contribution to funding in August of £32.8 million. The following points are of particular interest:-

(i) The largest net inflow of principal (£64 million) was still from Income Bonds although sales fell to £140 million - £43 million down on July. This reflected the perceived decline in the competitiveness of the interest rate.

(ii) Investment Account deposits also fell, to £121 million, but are expected to increase following the interest rate rise on 9 September.

(iii) Sales of fixed interest certificates rose to £170 million, with £140 million of this coming from reinvestment of matured certificates. Repayments, stimulated by reinvestment into 34th Issue, were high at £334 million.

(iv) Sales of index-linked certificates increased again in August to total £98 million, £55 million of which came from reinvestment. Repayments were also high following the crediting of the 6th supplement on 1 August.

Prospects to end-November 1988

3. The forecast has been based on the usual assumption that there will be no change to the rates offered to personal savers. However, it is complicated by the effects on many of the products of the postal dispute in September. DNS forecast a net

contribution in the period of £366 million. This would produce a total of around £1,007 million for the first eight months of 1988-89. DNS estimate the full year contribution will be around £1.7 billion.

4. The poorer performance of Income Bonds in August is expected to continue in September with sales, which have been affected by the postal strike, fully offset by repayments which were requested three months ago. The increase in the Income Bond interest rate announced on 26 August will come into effect on 9 October and sales are then expected to return to previous levels.

5. Inflows into and repayments from fixed interest certificates are also likely to have been affected by the postal dispute and may cause some distortion of the monthly figures. Total sales for the period are expected to be around £375 million with repayments at £740 million. The addition of accrued interest produces a net deficit of £155 million.

6. Recent inflation figures are likely to encourage sales of index-linked certificates to remain high with a forecast for the period of £230 million. The pattern of repayments is expected to steady following the surge of repayments following the August supplement. The net contribution to funding is expected to be around £51 million.

7. The increase in the rate of interest on Investment Account took effect on 9 September. Postal difficulties will have affected inflows with a net inflow of only £5 million forecast for the period. The addition of accrued interest produces a contribution to funding of £182 million.

MG1 DIVISION
23 September 1988

CONFIDENTIAL

NATIONAL SAVINGS NET CASH FLOW AND FUNDING CONTRIBUTIONS (£M)

1988-89

	Actual Results (April-August)	Forecast for Next 3 months Total	Likely Total Result to end November
Receipts less Repayments of Principal			
FINSC	-228	-40	-268
ILNSC	87	110	197
Investment A/C	21	5	26
Income Bond	573	180	753
Deposit Bond	41	22	63
Other	86	46	132
Total Net Inflow	580	323	903
Accrued Interest	897	468	1365
Accrued Interest Repaid	-836	425	1261
Net Accrued Interest	-61	43	104
NET CONTRIBUTION	641	366	1007 *

*

COST OF FUNDING : JULY
(Note by MG2)

Main Points

- Short yields have continued to move upwards faster than medium and long term yields increasing the downward slope of the yield curve. This results in a rise in the break-even yields by 0.2 per cent which on its own would reduce the cost advantage of shorts. However, the rise in current 10 and 20 year yields since July has raised the gap between current and break-even yields by 0.1 per cent and 0.01 per cent respectively thereby increasing the cost advantage of funding short.

- The real yield curve has risen slightly relative to the nominal yield curve at the short end but fallen against mediums and longs. The break-even inflation rates have risen which, given unchanged inflation projections, increases the attractiveness of indexed gilts.

- The equalising National Savings rates have risen in line with the increase in yields on conventionals. (See Table 2).

- In Table 3 it is assumed that building societies will increase their rates by ¾ per cent on 1 October. On this basis, income bonds will be pretty much in line with building societies after the increased rates come into force on 9 October.

MG2 Division
23 September 1988

SECRET

TABLE 1 GILTS:GROSS SALES

A. Gross Sales (net of purchases) (£billion)
Conventionals

	Shorts	Mediums	Longs	Total
1988-89 *	0.8	-0.0	-1.0	-0.2
Sept *	0.0	-0.0	-0.2	-0.2
Index Linked				
1988-89 *	0.2	0.1	0.4	0.7
Sept *	-0.0	-0.0	-0.0	-0.0

B. Average Life of Dated Gilts (years)

	All	Conventionals
End 1987-88	10.2	9.1
Sept *	10.0	8.9
Implied at end 1988-89 with no further buying in (1) :		8.7

- For every £0.5 billion of long dated stock bought in, the average life is reduced by 0.04 years (1)

* To 19 Sept 1988

(1) The longs are assumed to have an average life of 15 years and to be replaced by stock of 5 years maturity.

TABLE 2: BREAK-EVEN YIELDS, INFLATION AND NATIONAL SAVINGS RATES

Per cent

A: Break-Even Yields

	MTFS	Low	High	Weighted Projection	Latest HMT Forecast
(a) 10 Year	7.6	6.0	14.1	8.3 (8.1)	8.5
(b) 20 Years	7.7	6.1	14.3	8.4 (8.2)	8.6

B: Break-Even Inflation Rates

	Break-even Inflation Rate		Average Inflation Rate in Each Scenario				
			MTFS	Low	High	Weighted Projection	Last HMT Forecast
a. 5 years	7.3	(7.4)	3.3	2.5	6.1	3.6	4.5
b. 10 years	6.5	(6.4)	2.9	1.4	7.7	3.4	3.7
c. 20 years	5.5	(5.3)	2.7	0.7	8.7	3.3	3.1

C. Equalising National Savings Rates.

Per cent

	MTFS	Low	High	Weighted Projection	Last HMT Forecast
Rate on FINSC to match:					
5 year conventional gilt	8.2	8.1	8.4	8.2	8.3
20 year conventional gilt	11.4	13.1	5.2	10.7	10.3
Rate on ILNSC to match:					
5 year conventional gilt	4.9	5.6	2.3	4.6	3.8

- Bracketed figures refer to the last funding meeting
- MTFS,low and high scenarios are weighted 5:1:1
- The current rate on FINSC is 7.7%. The rate on an ILNSC is 4.2% (excluding inflation proofing). Both rates include administrative costs.

SECRET

TABLE 3 : NATIONAL SAVINGS INSTRUMENTS : VARIABLE RATE PRODUCTS.

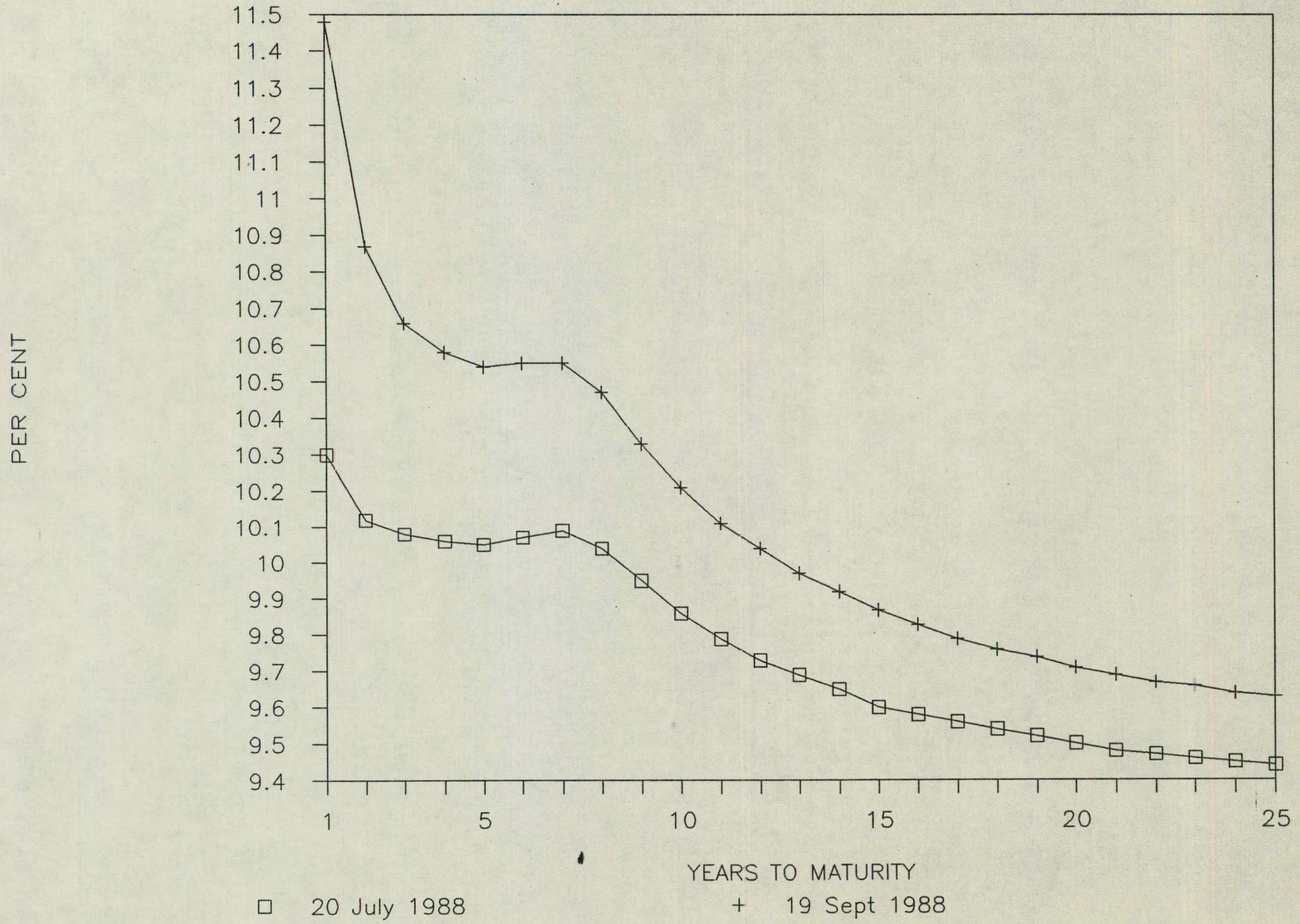
Compound Return	Per cent			
	Tax Rate (%)			
	0	25	40	Administrative costs
Income Bond (1)	11.2	8.4	6.7	0.2
Deposit Bond	10.8	8.1	6.5	0.3
Investment Account (2)	10.0	7.5	6.0	0.4
Premium Bond	6.5	6.5	6.5	1.1
Savings Certificate on GER terms	5.0	5.0	5.0	0.2
12 Month Cost of Government Borrowing (2)	11.5	8.6	6.9	-
CTDs	9.5	7.1	5.7	-
Bank Retail Deposit Rate (3)	8.0	7.8	6.3	N/A
Building Society Retail Deposit Rate (3)	8.5	8.3	6.6	N/A

(1) Assuming interest reinvested in Investment Account.

(2) Yield on a basket of gilts with maturities clustered around one year.

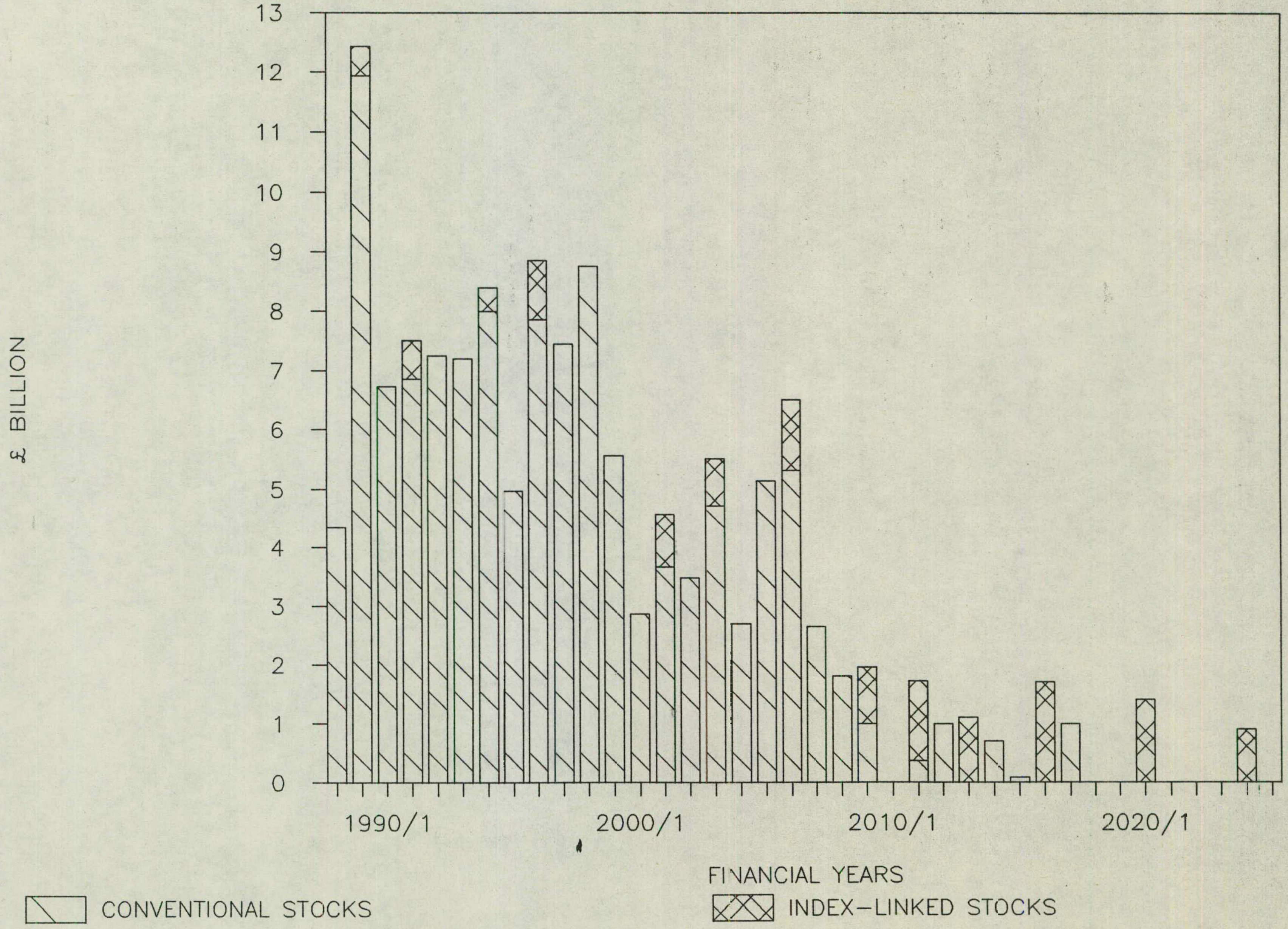
(3) Average of rates applying to the top bands of selected high interest accounts. Assuming an increase of .75 per cent on 1 October.

PAR GROSS REDEMPTION YIELDS



MATURITIES OF DATED UK GILTS

POSITION AT 19 SEPTEMBER 1988



mg2.jw.mg1.rydingfund

covering SECRET

~~BF 28/9~~

MP

FROM: CATHY RYDING

DATE: 26 September 1988

ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Scholar
Mr Peretz
Miss O'Mara
Mr Grice
Mr Rich
Mrs Davies
Mr Tyrie

Mr Patterson) DNS
Mr Wilson)

Mr Plenderleith - B/E
Prof Griffiths - No 10

FUNDING MEETING

I attach the Bank's paper on Gilt Edged Funding circulated for discussion under item (iii) of the agenda for the meeting on Wednesday 28 September.

Cathy Ryding

CATHY RYDING

GILT-EDGED FUNDING IN OCTOBER
(Note by Bank of England)

£ million

1 This note reviews the funding outturn so far in 1988/89 and outlines the prospects from October onwards.

Funding Arithmetic

2 Tables 1 and 2 show the latest forecast and the outturn so far this year (unadjusted and seasonally adjusted, respectively). There have been a number of substantial revisions to HMT's forecast since the last funding meeting at the end of July, reflecting the recent monthly figures:

(a) the PSBR surplus has been revised up from 7,400 to 10,000;

(b) the run-down in other public sector debt held by the NBPS is now assumed to total 1,000 during 1988/89, rather than 600.

(c) projected National Savings receipts have been revised up from 1,000 to 1,700;

(d) the forecast run-off in CTDs outstanding has been cut from 1,000 to 750;

(e) reflecting the outturn so far this year, and the much lower projected level of total gilt sales, the fall in bank and building society gilt holdings has been revised from 500 to 1,500.

3 The effect of these changes is that a full fund in 1988/89 now requires a fall of 9,[illegible]50 in the combined gilt holdings of the M4PS and overseas, as against a fall of 6,800 shown in the arithmetic for the last funding meeting. Allowing for the unwinding of last year's underfund of 400, and on the basis of a fall of 1,500 in bank and building society gilt holdings, this year's funding target requires net official gilt purchases, of all maturities, of

11,050. The forecast shows 8,300 of this being met by redemptions and purchases of stock with under one year to maturity; the remainder, 2,750, represents net purchases of stock with over a year to maturity. By end-August, we had made net sales of over one-year stocks of some 800, leaving a requirement to make net purchases of 3,530 between September and March next year. The forecast shows these contributing to an underfund of 900 over this period, offsetting the small overfund in the first five months. Thus far in September we have made net sales of over one year gilts of 70 (with the 370 call on the auction stock being largely offset by purchases). Therefore, on this arithmetic, a full fund would require net purchases of around 600 per month in the second half of the financial year. Were we to make further gross sales of stock, for example in the index-linked market, the gross buying-in total would be correspondingly increased.

4 There are, as always, very considerable uncertainties surrounding the funding arithmetic. The major revisions to the arithmetic so far this year have affected the PSBR, with the forecast surplus having been revised up from 3,300 at the time of the FSBR to 10,000 now: further changes cannot be ruled out. The intervention figure also must remain highly uncertain: the forecast assumes that the purchases of foreign exchange between April and August of almost 1,700 are reversed before end-March, and that the increase in the gilt funding requirement of 600 stemming from the reduction in the forward book to redeem the FRN is also offset. Since we cannot be sure about future exchange rate pressures (which may in any case be met by changes in interest rates rather than by intervention) we would see a more neutral assumption to be no intervention from now on. The variant in the tables shows that on this account the required total of buying-in between September and end-March would be reduced to about 1,300, a striking rate of only a little more than 200 per month, or much in line with that achieved so far. Bank and building society holdings of gilts have continued to be volatile, with a substantial fall so far this year. This has occurred against the background of rising short term interest rates and it remains to be seen whether the fall will be reversed in the second half year. Banks sold gilts in large scale early

last year, and mostly reversed this later on. If this pattern were to be repeated in 1988/89, the total of gilts we would need to purchase would again be reduced. Despite the uncertainties in the figuring, it is clear that there is a need for us to continue to make net purchases, and on the arithmetic above we would envisage purchases of the order of 200-500 per month, depending on market conditions. We will need to keep our operations under review as the funding arithmetic evolves.

Official operations

Table 3 shows the pattern of official operations in the first five months of the year. Gross sales of 780 between April and August largely represented sales of index-linked stock. During the same period, official net transactions in conventionals were close to zero, with net sales of 1,300 of shorts being offset by buying-in of stock in the longer maturities; this pattern has continued in September. Since the last funding meeting, at the end of July, we have been able to buy some in 800 of conventional gilts, concentrated in the longer maturities, reflecting the soggy market conditions during the summer.

Market conditions and funding tactics

Yields %	19 Oct 87 (peak)	20 Apr 88 (trough)	27 July 88 (last funding meeting)	21 Sept 88
Shorts	10 9/16	8 1/2	9 7/8	10 3/8
Mediums	10 9/16	9 1/8	9 7/8	10 1/8
Longs	10 1/16	9	9 1/2	9 5/8
IGs (2006) (real yield at 5% inflation)	4 11/16	3 3/4	3 15/16	3 31/32
Banks' Base Rates	10	8	10 1/2	12

6 Since the last funding meeting the further increases in short term interest rates have continued to push short and medium yields upward, though they are now a little below the peak reached early this month. Long rates have remained more stable, partly reflecting a view that the current deterioration in inflation may prove temporary, but also reflecting a continued improvement in the technical outlook, with market perceptions of the PSBR surplus, and hence the stock shortage, being revised up further. The short end

of the index-linked market has come off with the rise in interest rates, but longer indexed stocks have been more stable.

7 While perceptions seem to be that the current level of interest rates is broadly appropriate, this view may be vulnerable to adverse economic news and particularly to any weakening of the exchange rate. Thus the market outlook over the next few weeks remains uncertain, waiting for clear signs of the effects on demand of the interest rate increases. In such an environment there is unlikely to be substantial demand for new short conventional stock, though there may be demand for indexed stock (of which we hold some 400) and there should be opportunities to continue with our buying-in.

8 Against the above background, we will look to sell index linked stock when possible and will aim to operate in conventional stocks on the basis described above with buying-in focused on end-century and longer-dated stocks.

Bank of England

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Table 1

FUNDING [illegible]NANCIAL YEAR POSITION 1988/89 M4 BASIS £ millions
Not Seasonally Adjusted

	FORECAST	OUTTURN APRIL - AUG 1988	RESIDUAL SEPT 1988 - MARCH 1989 FORECAST	VARIANT b
PSBR AND FUNDING TARGET				
1 PSBR excl asset sales	- 3800	289	-4089	-4089
2 Asset sales (sales-)	- 6200	-4927	-1273	-1273
3 PSBR	-10000	-4638	-5362	-5362
Financed by:				
4 Other public sector net debt sales to M4PS (sales-)	1000	500	500	500
5 National Savings (sales-)	- 1700	-638	-1062(-152)a	-1062
6 CTDS (sales-)	750	149	601	601
7 Treasury bills etc M4PS (sales-)	0	65	-65	-65
8 Intervention (reserves inc+)	0	1669	-1669	0
9 External finance of public sector excluding intervention and gilts (increase-)	0	92	-92	508
10 Target net gilt sales to M4PS and overseas for full fund (sales+)	- 9950	-2801	-7149(-1021)a	-4880
11 Adjustment for 1987/88 underfund	400			
12 Over (-)/Under (+) funding	- 400	-1290	890	890
GILT SALES				
13 Net purchases by M4PS and overseas (purchases+)	- 9550	-1511	-8039	-5770
14 Net purchases by banks, b. socs and other public sector (purchases+)	- 1500	-1410	-90	-90
15 Maturities	8300	3699	4601	4601
16 GROSS OFFICIAL SALES	- 2750	778	-3528	-1259
17 Monthly average gross gilt sales	- 229	156	-504	-180

a Monthly average

Relationship between lines:
3 = 1 + 2
10 = 3 + 4 + 5 + 6 + 7 + 8 + 9
12 = 10 + 11 - 13
16 = 13 + 14 + 15

b Variant assumes no foreign exchange market intervention between September 1988 and March 1989; and that the effect of repaying 600 of the FRN from the forward book is not offset.

Table 2

FUNDING FINANCIAL YEAR POSITION 1988/89 M4 BASIS £ millions

Seasonally Adjusted

	FORECAST	OUTTURN APRIL - JUNE 1988	RESIDUAL JULY 1988 - MARCH 1989 FORECAST	RESIDUAL JULY 1988 - MARCH 1989 VARIANT b
PSBR AND FUNDING TARGET				
1 PSBR excl asset sales	- 3800	- 878	- 2922	- 2922
2 Asset sales (sales-)	- 6200	-4927	- 1273	- 1273
3 PSBR	-10000	-5805	-4195	- 4195
Financed by:				
4 Other public sector net debt sales to M4PS (sales-)	1000	588	412	412
5 National Savings (sales-)	-1700	-544	-1156 (-165)a	- 1156
6 CTDS (sales-)	750	339	411	411
7 Treasury bills etc M4PS (sales-)	0	108	-108	-108
8 Intervention (reserves inc+)	0	1669	-1669	0
9 External finance of public sector excluding intervention and gilts (increase-)	0	132	-132	468
10 Target net gilt sales to M4PS and overseas for full fund (sales+)	-9950	-3513	-6437 (-920)a	- 4168
11 Adjustment 1987/88 underfund	400			
12 Over (-)/Under (+) funding	-400	-2002	1602	1602
GILT SALES				
13 Net purchases by M4PS and overseas (purchases+)	-9550	-1511	-8039	- 5770
14 Net purchases by banks, b. socs and other public sector (purchases+)	-1500	-1410	-90	-90
15 Maturities	8300	3699	4601	4601
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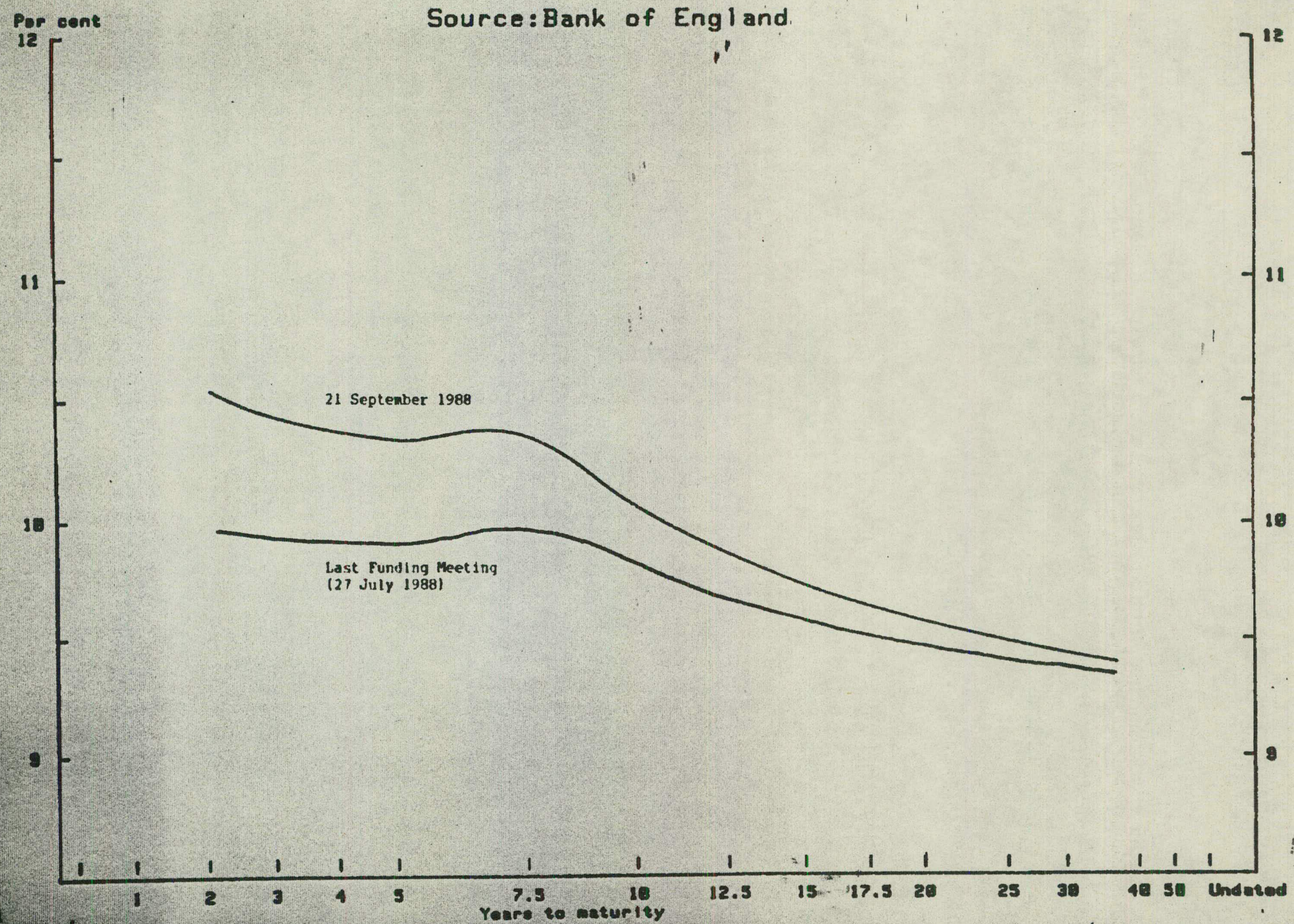
16 = 13 + 14 + 15

b Variant assumes no foreign exchange market intervention between September 1988 and March 1989; and that the effect of repaying 600 of the FRN from the forward book is not offset.

TABLE 3: OFFICIAL GILT-EDGED TRANSACTIONS 1988/89

£ million

	April-June	July-Aug	TOTAL April-Aug
Gross sales(+)/purchases(-) of over 1 year stock	882	-104	778
Short conventionals (0-7 years)	1,029	300	1,329
Medium conventionals (7-15 years)	-270	-245	-515
of which: maturities due 1996/97-1998/99	(-120)	(-53)	(-173)
maturities due 1999/2000-2002/03	(-35)	(-107)	(-142)
Long conventionals (15+)	-239	-560	-799
Index-linked	362	401	763
Maturities	-2,263	-1,436	-3,699
Redemptions	-1,845	-1,281	-3,126
Purchases of net maturities (0-1 year)	-418	-155	-573
Net Official Sales	-1,381	-1,540	-2,921


Source:Bank of England
Per cent
12
11
10
9
21 September 1988
Last Funding Meeting
(27 July 1988)
1
2
3
4
5
7.5
10
12.5
15
17.5
20
25
30
40
50
Undated
Years to maturity

eog5.ay29.9cr

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MINUTES OF A MEETING HELD AT 3PM ON WEDNESDAY 28 SEPTEMBER IN ROOM 47/2

Those present:

Economic Secretary
Mr Scholar
Mr Peretz
Mr Grice
Miss O'Mara
Mrs Davies
Mrs Ryding
Miss James

Mr George) Bank of England
Mr Plenderleith)
Mr Allen)
Mr Althaus)
Mr Mortimer-Lee)

Mr Patterson) DNS
Mr Ward)
Mr Hickman Robertson)

FUNDING ARITHMETIC

1. Mr Peretz said that the funding arithmetic was particularly difficult on this occasion because the forecast was not complete, but the outturn on the PSBR looked like being in the region of £10bn surplus. However, the average error at this time of year was in the order of £3bn either way. The arithmetic assumed zero intervention over the year as a whole. It was difficult to reach a firm view on whether this was plausible or not and the Bank's paper showed an interesting variant which assumed zero intervention from now on.

2. Continuing, Mr Peretz said that the National Savings forecast was £700m higher than had been assumed at the last funding meeting. CTDs were now only assumed to be run down by £3/4bn. At the last funding meeting we had been assuming that the bank and building society sector would purchase gilts over the remainder of the year, and we were now assuming virtually no change in their position.

3. On the basis of these assumptions, the arithmetic suggested buying in of around £1/2bn per month, or £200m per month assuming no intervention from now on.

4. Mr George said that there were uncertainties, but the clear message was that there needed to be consistent buying in from now. The numbers would largely be determined by market conditions. The Bank would buy in as much as possible without disrupting the market or driving it against themselves. The Bank's buying in operations had been noticed by the market, but not as an abrupt change, and this was helpful. However, it would become more visible when the statistics were published in the November BEQB. Mr Plenderleith noted that the downward slope of the yield curve was partly due to the Bank's buying in at the long end.

NATIONAL SAVINGS

5. Mr Patterson explained that for most of the year, the monthly results had made a £1bn figure for the financial year as a whole look low. This was a point he had stressed at the July meeting. It was true that the September results looked very odd, but that was due mainly to the postal strike which had affected Income Bonds in particular. August and September had seen a significant amount of repaying or reinvestment of savings certificates. The GER was now looking very uncompetitive, but was not having a particularly noticeable effect. The £1.7bn assumption for sales for the whole year did not include any allowance for the Capital Bond. Generally, rates were as near comfortable at the current time as possible.

6. Mr George said that he thought it was odd to encourage National Savings by issuing a new product, given the general funding position. Mr Scholar said that the Capital Bond was designed to provide low cost, quality funding and that compared well with policy in the gilts market. Mr Grice added that it was sensible to restructure the outstanding debt and cost and quality arguments were central. Mr George questioned whether in the event the Capital Bond would offer good quality funding.

GILT EDGED FUNDING

7. Mr George said that technical considerations were emerging as a stronger and stronger factor. The negative effect of overheating worries had lessened over the last two weeks, and there was a general view that 12 per cent interest rates would be

enough. The latest trade figures had removed a potential obstacle to market improvement. He could see the market rallying quite sharply, although not necessarily for the next few weeks. At the short end, it might be necessary to take cooling action. There was also a risk that the market could be upset by events on the international scene.

8. Continuing, Mr George said that the market outlook was not particularly good for buying in, and the Bank were likely to be out of the market during its rally. But after that, they should be able to buy in.

9. The Economic Secretary asked whether the gilt market was suffering from the lack of primary sales. Mr George said that this was a worry, but the salvation was the market in non-Government sterling debt. The removal of the limit on sovereign borrowers had proved helpful. Those firms not well placed to operate outside the gilt market were particularly pessimistic. There was a worry too about the long gilt future which depended critically on benchmark securities. The Bank were also now able to undertake more switching activity and this was helpful.

BUYING IN TARGET

10. The Economic Secretary explained that conventionally we should set a target for the next quarter, but on this occasion as no decisions had yet been reached on the reverse auction, he thought it best just to consider October. The arithmetic suggested a target of £$^{1}/2$bn. Mr George said that if market conditions were as expected the Bank might get close to this figure, but if they proved worse than expected it could be difficult. Mr Peretz noted that the Bank would continue to sell IGs from their books where there was demand.

COST OF FUNDING

11. Mr Peretz said that since the last meeting the yield curve had tilted and the level had risen. The tilt in the yield curve made 5 year debt less attractive to borrow and the increase in the curve offset this. These mechanical effects assumed an unchanged view of interest rates in 5 years time. Recent events must have

increased the uncertainty on the outlook for interest rates. He also felt it worth considering whether, given the high buying in requirement, we should buy in very short gilts, partly on the grounds of cost and partly on monetary policy grounds. However, it was agreed that this should be considered in the context of reverse auctions.

MONEY MARKET ASSISTANCE

12. Mr Allen explained that the Bank had now embarked on the programme of enlarged Treasury bill tenders to smooth out the rise in money market assistance in January. The figures were of course very uncertain, but the increase in January could be around £4^1/2bn, with rapid relief in February due to the gilt maturity. The stepped-up tenders had started earlier this year than last year and we were planning five weeks of extra sales of three month bills in October, and probably issues of two month bills in November. One £400m tender had already taken place and a further tender had been announced. It would be important to keep the amounts under review, but assuming the bills stayed in the market he was hopeful that the policy would go quite some way towards smoothing the build-up of money market assistance. Last Friday's tender had been covered five times at quite attractive rates, and this week's tender could be even better. It appeared that there was substantial investment demand for Treasury bills, possibly triggered by the announcement of higher tenders.

Cathy Ryding

CATHY RYDING

Circulation: Those present
PPS
PS/Sir P Middleton
Sir T Burns
Sir G Littler
Prof Griffiths - No 10
Mr Tyrie

RP

NOTE OF A MEETING IN THE CHANCELLOR'S ROOM HM TREASURY AT 6.30PM ON MONDAY 17 OCTOBER

Present: Chancellor
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mrs Lomax
Mr Grice
Miss O'Mara
Mrs Ryding

REVERSE GILT AUCTION

The Chancellor noted that the Bank of England had reservations about announcing a reverse gilt auction in the Mansion House speech, and were anyway not yet ready for an announcement. It was arguable that the Bank might have moved ahead faster, but with such tight deadlines he thought the only sensible course was to go back to the original idea of announcing this in the Autumn Statement, if we did decide to proceed with it. This gave a reasonable amount of time to sort out the issues - though it was now possible that the Autumn Statement would be earlier than had originally been thought.

2. At the Mansion House he would certainly want to announce that we would not hold another auction this year, and would wish to say something about funding, unfunding, overfunding etc. But the uncertainty of the funding arithmetic was an argument against announcing a reverse gilt auction.

3. There was some discussion about the Bank's achievements in buying in gilts. Purchases had started slowly, but their pace had picked up rapidly, following pressure at the Economic Secretary's funding meetings, and they were now at a much higher

level - although still short of what needed to be achieved over the rest of the year. The Bank's initial caution probably arose because they probably had not believed the funding arithmetic earlier in the year. Sir P Middleton stressed that it was important that they should not get too far behind the full year funding target.

ACSA

A C S ALLAN
18 October 1988

Distribution

Those present
Sir G Littler
Mr Peretz or

novstl.4

FROM: J C J RAMSDEN
DATE: 9 November 1988

1. MR MCINTYRE

I agree
J
9/11.

2. FINANCIAL SECRETARY

cc Chancellor
Chief Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mrs Lomax
Mr Peretz
Miss Peirson
Mr Culpin
Mr Ilett
Mr Speedy
Mr Bolton
Mrs Chaplin
Mr Lewis IR
Mr Evershed IR

Ch/ I think we should wait for more evidence before taking action. But - if you agree - I will minute out saying that you would like this watched very closely.
10/11

Agree.

PAYMENT IN EQUITIES

We have heard from the Inland Revenue of a case in which a company which previously paid bonuses in gilt-edged stock has now paid bonuses in equity shares of publicly quoted companies. In all, eleven employees received £44,000 from the company in this way.

2. You will remember that DSS introduced new regulations in May making payments in the form of gilts and other debt instruments subject to NICs. DSS Ministers, with your agreement, made it clear at the time that if evidence emerged of employers using other securities to evade NICs, the Government would take further action.

3. Mr McIntyre minuted on 18 July about a press report that Warburgs would be paying bonuses to their staff this year in units of unit trusts. You commented (Mr Satchwell's minute of 19 July) that we should probably act if any more evidence came to light. The Chancellor said (Mr Taylor's minute of 21 July) that he would want to be consulted before any action were to be taken.

4. DSS officials appear uncertain whether to recommend early action, since firms have clearly cottoned on to this loophole, or to wait until a package of NIC avoidance measures can be assembled, in the hope of plugging all the holes in one go. But as

they only have two cases to go on they are inclined, in any case, to wait for more evidence. Unless you want to write to DSS Ministers at this stage, I suggest that we continue to keep you informed of any further evidence and keep the case for action under review.

J C J Ramsden

J C J RAMSDEN

chex.ps/jmt/72 RESTRICTED

FROM: J M G TAYLOR
DATE: 11 November 1988

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mrs Lomax
Mr Peretz
Miss Peirson
Mr Culpin
Mr Ilett
Mr McIntyre
Mr Speedy
Mr Bolton
Mr Ramsden
Mrs Chaplin

Mr Lewis - IR
Mr Evershed - IR

PAYMENT IN EQUITIES

The Chancellor has seen Mr Ramsden's note of 9 November.

2. He agrees that we should wait for more evidence before taking action. But he would like this watched <u>very</u> closely.

J M G TAYLOR