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'The capital market is dead.' The difficult birth of index-linked gilts in the UK

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Abstract:	This article describes how and why the Thatcher government introduced index-linked gilts in 1981. We describe the earlier deliberations by the monetary authorities during the 1950s and 1960s on how an indexed government security might help or hinder the fight against inflation. Although these discussions came to nothing, rising inflation and increasing difficulties with managing the gilt-edged market during the 1970s revived interest in the indexation of government securities. Both the Page Commission in 1974 and the Wilson Report in 1980 recommended the introduction of inflation-indexed securities, but the election of the Conservative government in 1979 gave real momentum to their possible issuance. Although Margaret Thatcher was initially opposed to indexation, Nigel Lawson galvanised the Treasury and the Bank of England to work on a scheme to issue index-linked gilts as a means of improving economic performance. The article traces the contentious series of discussions surrounding the possible effects of index-linked gilts on Government debt interest costs; on monetary policy and monetary targets; and on the possible 'crowding out' of corporate bonds and equities which could not offer a guaranteed real return. Despite teething problems, the introduction of inflation-linked bonds in the UK was deemed a success.

In the 1981 Budget, Chancellor Geoffrey Howe announced the first issuance of index-linked gilts (that is, government securities adjusted in line with movements in inflation), which were eligible for purchase by UK pension and life assurance companies. The Financial Secretary to the Treasury, Nigel Lawson, who was pivotal in their introduction, claimed that this move was comparable in importance with the abolition of exchange control in September 1979.[1]

With the introduction of index-linked government bonds, the UK became by far the largest country to issue an index-linked financial instrument. Over the course of the 1980s and 1990s, other countries followed suit: Australia in 1985, Mexico in 1989, Canada in 1991, Sweden in 1994 and New Zealand in 1995.[2] In the United States, index clauses in loan contracts were unenforceable between 1933 and 1977, and it was not until January 1997 that Treasury Inflation Protected Securities (TIPS) were introduced.[3] Stiglitz has remarked that his experience with persuading the Clinton administration in the US to accept indexed bonds was a 'long and difficult process' and, as this article shows, this description applies equally to the UK.[4]

Compared to other asset classes, the body of research on the history of index-linked gilts is thin. There are a number of published academic studies on the performance of UK index-linked gilts, but none are historical in content.[5] Moreover, aside from an

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[1] Bank of England Archives (hereafter BEA), 7A133/2, 'Note of a meeting', 17 July 1980.

[2] For a survey, see Price, 'The rationale'. Index-linked New Zealand bonds were introduced in 1977 but discontinued in 1984 following a change of government.

[3] McCulloch, 'The ban'.

[4] Stiglitz, 'The private', p. 7.

[5] Rutterford, 'Index-linked gilts'; Bootle, *Index-linked*; Arak and Kreiche, 'The real'; Barr and Campbell, 'Inflation'; Campbell, Shiller and Viceira, 'Understanding'; Goodhart, 'UK indexed gilts'.

account in Nigel Lawson's memoirs – and then only as a brief appendix – the story of how and why the Thatcher government introduced index-linked gilts has not been told.[6] Using official papers from the archives of the Bank of England (the Bank), the Treasury and Prime Ministerial files, this paper explores the difficult birth of index-linked gilts in the UK and is divided into five parts.

We first consider the discussions about indexation by the Treasury and Bank up to the 1970s. For much of the 1970s, government financing was at negative *ex post* real interest rates, leading to market scepticism about the anti-inflationary resolve of the authorities. Despite growing concerns about the management of the gilt-edged market, indexation was not seriously considered at the time as a means of addressing any deficiencies with the techniques of gilt sales. Section 2 discusses the gradual moves towards index-linked gilts from January 1980 as Nigel Lawson argued for a renewed focus on reducing the Public Sector Borrowing Requirement (PSBR) and on money supply targets. Over a six-month period, Treasury and Bank officials worked on a scheme for issuing index-linked gilts. We explore the complications which arose and the divisions between officials in the course of these discussions. Section 3 considers the options which were presented to the Prime Minister in the autumn of 1980. We examine the further complications that arose and how Lawson, with the support of Alan Walters, the Prime Minister's personal economic adviser, managed to persuade the Chancellor and the Prime Minister to agree to issue an index-linked gilt in the March 1981 Budget. Section 4 briefly considers the outcome of the first call for the issue of index-linked gilts. Finally, we provide some conclusions.

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[6] Lawson, *The view*, pp. 114-118.

I

A long line of economists, stretching back to the early nineteenth century, has advocated the use of indexation in financial markets, particularly for debt instruments.[7] One of the strongest arguments from the proponents of index-linked debt has been that both debtor and creditor should be protected from the adverse effects of inflation: as Irving Fisher noted, ‘the ideal is that neither debtor nor creditor should be worse off from having been deceived by unforeseen changes’.[8] Although the US had experimented with indexed bonds in the eighteenth century, it was only post-1945 that indexation was introduced, most prominently in developing countries, as a response to inflation. Table 1 shows the dates of introduction of government bonds, indexed to consumer or wholesale prices, in various countries of the world prior to the mid-1970s.[9]

** Table 1 here **

[7] Lowe, *Present*; Jevons, *Money*, p. 324; Marshall, ‘Remedies’; Fisher, *Purchasing*; Keynes; ‘Minutes’, pp. 278 and 287; Friedman, ‘Purchasing’, p. 86, ‘Economic miracles’, p. 80 and ‘Monetary correction’. Nelson, *Milton Freidman*, pp. 76-77, suggests that Friedman was convinced of the need for indexed bonds as early as 1942 and began to advocate their introduction in public during the 1950s. Humphrey, ‘The concept’, provides an excellent survey on indexation.

[8] Fisher, *Purchasing*, p. 210

[9], For discussion on Finland see Mukherjee and Orlans, *Indexation* and Junnila, ‘Finland’; for Iceland see Jónsson, ‘Financial’; for Brazil see Baer and Beckerman, ‘Trouble’ and Kleiman, ‘Monetary’; for Chile see Shiller, ‘Indexed’. France issued indexed bonds from 1952 linked to the price of the gold Napoléon and discontinued in 1958; see Rozental, ‘Variable-return’. A detailed account of what is believed to be the world’s first inflation-indexed bond in Massachusetts in 1780 can be found in Shiller ‘Invention’ and Fisher, ‘Tabular’.

Discussions on issuing indexed financial instruments occurred in the UK after 1945, most notably during times of worsening inflation, when it was difficult for the authorities to sell non-marketable National Savings and marketable bonds (gilts).[10] When the Bank was asked by the Chancellor of the Exchequer, Hugh Gaitskell, to consider indexation of government bonds in 1951, it rejected their introduction on three grounds. First, indexed bonds would only address the symptoms of inflation rather than its underlying causes; second, their introduction would constitute a public admission that the purchasing power of the pound was likely to fall and, finally, the Bank was concerned that it would encourage indexation to be extended to other forms of savings.[11] The extension of indexation was also something that concerned the Radcliffe Committee, when they published a report on the workings of the British monetary system in 1959, warning that indexation would lead to a major alteration in the working of the economic system, accelerate inflation and would represent a 'confession of failure' in the face of inflation.[12]

In September 1964, interest in indexing government bonds was reignited by a report in the *Financial Times* that a committee of experts in Sweden had recommended that the Swedish government should issue a limited amount of indexed bonds as an experiment.[13] The *Financial Times* suggested that the British government should do the same, but the Bank took refuge in the views of the Radcliffe Committee and dismissed the Swedish idea, noting that the experiences of other countries 'have not

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[10] Goodhart, 'UK indexed gilts', p. 92.
[11] BEA 6A42/1, 'Government securities and the cost of living', 7 May 1951; Allen to Mynors, 'Government securities and the cost of living', 8 May 1951.
[12] *Report of the Committee on the Working of the Monetary System*, British Parliamentary Papers 1959, Cmnd. 827, para. 573.
[13] 'A notable conversion to index-linked saving', *Financial Times*, 5 Sep. 1964.

been happy' and that the UK should 'hesitate long before joining such strange bedfellows as Finland, France, Mexico, China and Israel'.[14]

The Treasury had independently considered the case for indexation in the mid-1960s. Whilst it rejected indexation, the Treasury produced a more balanced assessment than the Bank. Their main arguments against the introduction of index-linked bonds were that it was a confession of failure by the Government in the fight against inflation; that servicing costs could become large depending on the choice of index; it might be difficult to find a suitable index for linking the bond; and the introduction of index-linked savings might make borrowing more difficult and 'lever up' interest rates generally so the government paid more on the same volume of savings.[15]

In 1970, *The Economist* published two articles criticising British monetary policy and suggested that the introduction of an index-linked gilt would help the government control the money supply.[16] Unsurprisingly, a review by Treasury officials did not support the suggestions made by *The Economist*, concluding that there was no case for index linking any part of government debt. Painter, a Treasury official who had written a comprehensive summary of the pros and cons of indexation in 1967, tried to shut the debate down once and for all:

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[14] BoE 6A42/1, 'Index bonds', 10 Sep. 1964, Economic Intelligence Department to Heasman; 'Indexed linked bonds', 11 Sep. 1964. China had introduced index-linked 'Victory Bonds' in 1950 linked to wholesale prices, but these were quickly abandoned, see Burdekin and Wang, 'Novel end', p. 225.
[15] The National Archives, Kew, London (hereafter TNA), T326/488, 'National Savings Certificates', n.d. Also see TNA, T230/738, 'Debt management – the view ahead', Cassell to Cairncross, 6 Dec. 1965.
[16] 'The man who stepped out', *The Economist*, 31 Oct. 1970, p. 12; 'Any road from ruin', *The Economist*, 7 Nov. 1970, p. 18.

> If there is a Chancellor's meeting on savings generally in the near future we could report that index-linking is dead … I appreciate that this means that *The Economist* will prattle on. But the conclusive arguments against index-linking (destroying money illusion, identifying expected rates of inflation, and confidence factors generally) are precisely those which cannot be deployed.[17]

At the end of July 1972, the Chancellor asked for contingency planning to be undertaken by both the Treasury and the Bank in the event of a breakdown in pay talks between the government, the Confederation of British Industry and the Trades Union Congress and gilts were not able to be sold by conventional means.[18] The Treasury was cautious about inviting the Bank to join this planning exercise, as they feared the Bank would be hostile.[19] The Bank viewed indexation in these circumstances as a last resort in an extreme situation and believed that any indexed gilts should be non-marketable. *Per contra*, the Treasury explored how to devise an index-linked market security with the most likely purchasers being the insurance companies and pension funds. The joint paper concluded that it was unwise to embark on introducing indexed bonds until the possibilities of selling conventional fixed interest stock had been exhausted; and that position had not yet been reached.[20]

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[17] TNA, T326/1344, Allen to Figgures, 30 Oct. 1970; TNA, T326/1103, 'Index linked National Savings', Painter to Radice, 22 Dec 1967; TNA, T326/1345, 'Index-linked and other variable securities', Painter to Neale, 8 Feb. 1971.
[18] See Holmes, *Political*, pp. 79-84, for coverage of the tripartite talks.
[19] TNA, T326/1649, 'Index linked government securities', Unwin to Downey, 2 Aug. 1972; BEA, 5A44/6, 'Index linked government securities', Unwin to Bumpus, 6 Sep. 1972 and enclosure.
[20] TNA, T326/1649, 'Index linking', Downey to Manghan, 17 Oct. 1972 and enclosure.

Despite the contingency planning exercise, neither the Bank nor the Treasury modified their views on indexation. The Treasury drew succour from the preliminary conclusion of an OECD report in 1973 that bond indexation was not a panacea for inflation and would reduce the efficiency of capital markets.[21] As Goodhart has noted, officials also feared 'contagion', that is, financial indexation would spill over to other, much less desirable, forms of indexation including government expenditure and wages. Indeed, the Heath government's experiment in 1973 with wage indexation beyond a threshold was seen by the Bank and the Treasury as particularly disastrous: the external oil price shock in late-1973 had triggered the thresholds and the internal wage/price spiral was worse than in virtually any other country.[22]

The Treasury and the Chancellor had thus become jittery about the potential outcome of a Royal Commission to review national savings (the Page Committee), which they feared could lead to experiments with indexation on a wide range of contracts. However, the tide was beginning to turn. Both the Page Committee, which reported in 1973, and the Wilson Committee, which was set up in 1976, were influenced by the inflationary environment of the 1970s and adopted a different tone to the Radcliffe Committee which had reported in 1959. The Page Committee suggested a scheme for how indexing financial instruments might work.[23] Despite the merits of the case for providing an inflation-hedged financial asset, due to fear of contagion, the government did not follow the full scheme recommended by Page and

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[21] TNA, T233/2552, Kelley to Nendick, 29 March 1973 and enclosure; Committee on Financial Markets, *Indexation*. A follow-up report by the OECD two years later was less agnostic on indexation, see OECD, *Indexation*.
[22] Goodhart, 'UK indexed gilts', p. 93.
[23] *Report of the Committee to review national savings*, British Parliamentary Papers 1973, Cmnd. 5273, paras 583-586.

instead, in 1975, issued two National Savings contracts limited to small savers which guaranteed the maintenance of their purchasing power, as measured by the Retail Price Index (RPI).[24]

The Wilson Report published in 1980 reflected general concern with inflation risk by devoting two chapters to the impact of inflation on capital markets and to the need for index-linked securities.[25] The Wilson Report considered that one of the major problems caused by high and volatile rates of inflation was the impact on both government and corporate funding.[26] It was also concerned with the impact of inflation on the real value of investors' savings. Given the importance of pension funds as major investors in gilts and given their particular need to provide pensions based on earnings, the Wilson Committee recommended that the government should issue gilts linked to an index of average earnings, which could only be acquired by pension funds.

During the 1970s, both the proportion of the PSBR funded by gilt issues (see Table 2), and the coupons attached to these gilts, increased substantially. By 1980, £29 billion of gilts with coupons in excess of 10 per cent and maturities of 10 years or above were in issue. The interest payments on these gilts were of the order of £3.5 billion each year, a substantial sum when compared with the 1980 PSBR of £11 billion. The Wilson Committee recognised that these high-coupon, long-dated gilts left the government vulnerable to the risk that, should inflation fall, the *real* burden of

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[24] Investment in these non-marketable certificates was originally limited to pensioners, earning them the sobriquet 'granny bonds'.
[25] *Report of the Committee to review the functioning of financial institutions*, British Parliamentary Papers 1980, Cmnd. 7937, Chp. 5 and 17.
[26] 'The growing case for indexed government borrowing', *Financial Times*, 13 Nov. 1976.

its debt interest would rise. Figure 1 shows the actual annual inflation rate, as measured by the RPI, for the period 1960-1981.

** Table 2 and Figure 1 here **

As Capie notes, one of the features of the late 1970s was the high level of ministerial interest in the gilt-edged market.[27] In early June 1978, the Cabinet discussed how it was becoming more difficult to sell gilt-edged securities to the private sector because of the growing size of the PSBR and attributed these difficulties to the current organisation of the gilt edged market.[28] Gavyn Davies, an economic adviser to the Number 10 policy unit, suggested that the Bank was 'too conservative' and unwilling to give new issuance methods a try.[29] Davies recommended the introduction of an indexed bond and also the setting up of an inquiry into the system of selling gilts which would report directly to James Callaghan, the Prime Minister. Following further discussions, Callaghan was presented with a paper in favour of an inquiry into techniques for controlling the money supply and for marketing public sector debt.[30]

However, the Chancellor, Denis Healey, had already decided to commission a study of the gilt market by a joint Treasury and Bank Working Group.[31] This was chaired jointly by Michael Bridgeman, an Under Secretary in the Treasury, and John Page,

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[27] Capie, *The Bank*, p. 691.
[28] TNA, CAB 128/64, 'CM (78) 21st conclusions', 8 June 1978.
[29] TNA, PREM 16/2015, 'Gilt Sales', 9 June 1978.
[30] TNA, PREM 16/2015, Wicks to Callaghan, 12 June 1978.
[31] TNA, T388/14, 'Gilts market and the control of the money supply', Bridgeman to Littler, 21 June 1978; PREM 16/2015, 'Money supply and the gilt edged market', 22 June 1978.

Chief Cashier in the Bank, and reported its preliminary conclusions in July 1978.[32] The report drew on the work which had been undertaken by both institutions over the previous twenty years, and the thrust was against the issuance of index-linked gilts for four reasons. First, it would ‘crowd out’ industrial finance as pension funds would buy index-linked gilts rather than corporate securities; secondly, few industrial borrowers would be able to take advantage of this new type of security as they would not be able to take on the open-ended commitment involved in index-linked borrowing; thirdly, there would be a relative advantage of government issues over comparable indexed bonds by companies and local authorities which did not share the same Capital Gains Tax (CGT) advantages, and this would require legislation to equalise the tax treatment; and, finally, indexation in the capital market would increase the pressure to extend indexation to other parts of the economy and be a sign that inflation would persist in future years.

Although the report noted how an indexed bond could provide extra government finance and smooth public debt sales, it concluded: ‘The balance of argument seems still to be against introducing a marketable index-linked bond for as long as there is a prospect of the rate of inflation continuing on a downward trend’. The report recognised that the government might be forced to issue such a security if inflation were again to shift upward but did not recommend any policy initiative in this area ‘at this stage’.[33]

[32] A copy of the report can be found in TNA, PREM 16/2015, ‘Monetary Control I. The Gilt Edged market’. In 1975, Michael Bridgeman had chaired a Treasury/Bank group which had suggested that new variable-interest and indexed-linked stocks needed to be examined; Capie, *The Bank*, p. 666 notes that at this time, Page ‘did not like such things’ and the Government Broker was not in favour of innovations in the gilt-edged market.
[33] TNA, PREM 16/2015, ‘Monetary Control I. The Gilt Edged market’, para. 40.

Callaghan expressed his reservations about the joint Treasury/Bank Working Group's report and informed Healey that he was 'not wholly convinced by the arguments…about how satisfactory are present arrangements for monetary control' and hoped that 'the final report will give fulland serious consideration to alternative methods such as indexed bonds, tender selling or public sector debt ratios for the institutions'.[34] Despite the suggestion that there should be a seminar, a 'green paper' or an article in the *Bank of England Quarterly Bulletin*, the topic of gilt-edged issues was temporarily put aside because of more pressing concerns, which included the need to extend the monetary target and on-going discussions on the Minimum Lending Rate (MLR).[35]

Bank and Treasury officials had not shown any great enthusiasm for index-linked gilts in their joint Working Group and a follow-up report by officials was broadly negative, leading Bernard Donoughue, the head of the policy unit in Downing Street, to comment to Callaghan that 'it is possible that they are right to argue that the present system is the very best available, but there remains a suspicion the official group may not have been completely open-minded in its approach'.[36] Despite the negativity shown to index-linked gilts, Treasury officials were acutely aware of how the recent high level of inflation in the UK had distorted behaviour for consumers, businesses and financial markets. The inability of the accounting profession to recommend a suitable accounting method for companies to be able to show real

[34] TNA, PREM 16/2015, 'The Gilt-Edged Market', 9 Aug. 1978.
[35] Capie, *The Bank*, pp. 693-94; TNA, PREM 16/2015, 'The gilts market', 5 March 1979.
[36] TNA, PREM 16/2015, 'The seminar on monetary policy', Donoughue to Callaghan, 7 Nov. 1978; 'The Gilt Edged Market – a further report by officials', n.d.

rather than nominal profits – and be taxed accordingly - reflected the complexity of the issue. In fact, Denis Healey did not wait for the recommendations on this topic from the Sandilands Committee, published in 1975; he introduced stock appreciation tax relief in November 1974.[37]

In the summer of 1978, the Treasury prepared a general paper on indexation with the assistance of the Financial and Economic Unit (FEU) in the Treasury. The paper gave an extended treatment to the design of an index-linked bond, including issuance techniques, and dealt with uncertainty in the real purchasing power of such bonds in the future; the capital uncertainty on maturity which it was likely only a government would be willing to incur; and how indexing could eliminate the front loading that high nominal interest rates on a bond entailed, which would have beneficial effects on PSBR and monetary control.[38]

The Bank and Treasury had managed to resist the introduction of any sort of index-linked security during the 1950s and 1960s, but as concerns about inflation grew in the 1970s, there did appear to be a gradual acceptance that the strength of the argument for indexation depended on the contract or market under consideration. Thus, the equity arguments in favour of inflation-hedged financial instruments for pensioners, who needed protection from unanticipated inflation, were far greater than for wage earners, who were in a stronger position to protect themselves.[39] Moreover, as the authorities began to experience practical difficulties in selling fixed-interest debt in the inflationary environment of the 1970s, politicians showed a

[37] Robson, 'Inflation'.
[38] TNA, T388/14, Williams to Bridgeman, 13 July 1978 and the paper entitled 'Indexation' which follows.
[39] Goodhart, 'UK indexed gilts', p. 91.

growing interest in the possible issuance of indexed bonds. Following the decision to publish targets for the money supply in 1976, the UK's monetary authorities placed a renewed emphasis on selling gilt-edged stock to the non-bank private sector in order to hit the money supply targets.[40] The election in May 1979 of a Conservative Government, which placed monetary targets centre stage in their attempt to bear down on inflation, soon led to a renewed interest in index-linked gilts.

II

The Conservative Government faced a considerable number of economic challenges upon taking office, notably the requirement to bring down inflation and to reduce the PSBR. For both, effective operations in the gilt-edged market were crucial.

According to Sir Adam Ridley, economic adviser to the Shadow Cabinet between 1974 and 1979, the Conservatives when in opposition had spent little time discussing index-linked gilts and had made no plans to introduce them if they were elected. However, Ridley did send his thoughts on indexation to Margaret Thatcher in 1976, following a suggestion in the *Financial Times* that the Labour Party was contemplating introducing index-linked bonds. Whilst not ruling out indexation of bonds, Ridley noted that if this were to occur there would be pressure for indexation of wages and taxation. Thatcher underlined what Ridley regarded as the most

[40] Dimsdale, 'British monetary', p. 126, provides a discussion.

serious consequence of indexation, namely that 'it would push up the real rate of interest, or at least sustain it at roughly its present level'.[41]

In opposition, Margaret Thatcher had consulted with one of the City's leading monetarists and expert on the gilt-edged market, Gordon Pepper of the City firm W. Greenwell and Co. Pepper was well aware of the difficulties the authorities were facing with operations in the gilts market, and in May 1979, after the Conservative victory in the General Election, he urged Thatcher, now Prime Minister, to take decisive action on reducing public expenditure and to impose strict control of the money supply.[42] Pepper complained that the previous Labour administration had issued too much long-dated fixed-rate gilt-edged stock and suggested that there should be some short-term debt issues; equity-type debt (Pepper had in mind sales of public sector assets to UK residents); and a one-off issue of an index-linked gilt-edged stock as 'a solution of last resort'.[43]

For Pepper, the key to controlling inflation was the introduction of a system called monetary base control (MBC).[44] Although Thatcher recognised the dangers of making sudden changes to the banking system, the scheme appealed to her and

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[41] Correspondence with Sir Adam Ridley; Churchill Archives Centre (hereafter CAC), THCR 2/12/2/1, Thatcher to Ridley, 9 Nov. 1976.
[42] TNA, PREM 19/183, Pepper to Stephens and the enclosure, 'Assessing the budget', 16 May 1979; PREM 19/183, 'Note for the record', 18 May 1979.
[43] TNA, PREM 19/183, Pepper to Stephens and the enclosure, 'Assessing the budget', 16 May 1979.
[44] Pepper's version of an MBC system at the time required all banks to hold deposits with the Bank and only the authorities could determine the size of the monetary base. See CAC, THCR AS 3/17/20, 'A monetary base for the UK: a practical proposal', 2 July 1979.

also to Nigel Lawson, the Financial Secretary to the Treasury.[45] Pepper met with Thatcher twice in July 1979 and sharpened his criticism of the Bank's policy of issuing too much long-dated stock and not enough shorter-dated stock.[46]

Thatcher had asked for a seminar to be held on monetary policy in July 1979, and a briefing paper sent to her noted that 'Ministers may wish to consider whether there is a sufficient *prima facie* case in favour of issuing some index-linked stock, on the grounds that it would be cheaper, to justify a detailed examination of its pros and cons of how it might be achieved'. The paper struck a balanced note in its assessment of indexation and questioned whether it was the right time to make 'fairly profound, but unpredictable changes in the capital market at the time when the government is committed to bring down inflation sharply'.[47] Thatcher was also sent an article on the gilt-edged market which had been published in March 1979 in the *Bank of England Quarterly Bulletin*. The Bank's tone was more cautious than that of the Treasury, and drew attention to the wider context of indexation in the capital market, cautioning against indexation 'solely as an expedient to facilitate gilt-edged market management'.[48]

Lawson raised the issue of indexation at the seminar on monetary policy in July 1979 and received an unfavourable reaction from the Prime Minister, who said she was

[45] TNA, PREM 19/183, 'Note for the record', 18 May 1979; TNA, T364/187, 'Monetary base', Lawson to Middleton, 10 July 1979.
[46] TNA, PREM 19/183, 'Note for the record', 4 July 1979 and 25 July 1979.
[47] TNA, PREM 19/33, 'Funding the PSBR and gilts market', which accompanies a note to Thatcher from Howe, dated 13 July 1979.
[48] Bank of England, 'The gilt-edged market', p. 147.

'strongly opposed' to the issuance of index-linked stock.[49] According to Lawson, Margaret Thatcher was initially 'instinctively opposed to indexation as in some way validating inflation'.[50] Her early antipathy might possibly have been due to her experiences with wage indexation as a member of Edward Heath's Cabinet in 1973, but ultimately she appears to have been convinced by the arguments advanced that the introduction of indexed-linked gilts would assist in funding the PSBR, provided inflation came down.[51]

During the autumn of 1979, the monetary situation deteriorated. The monetary targets for 1979-80 were in danger of being missed (£M3 had grown by 7.3 per cent in the first six months of the financial year compared with 5.3 per cent in the forecast) and higher oil prices and increases in pay settlements threatened to breach the public expenditure limits, which had been announced in the June Budget.[52] Thatcher was informed that there was a threat of a potential buyers' strike in the gilt-edged market unless MLR was raised.[53] The gilt strike of summer 1976, which had been a factor in MLR being raised from 11.5% to 15% in the autumn of that year, was also fresh in their minds.[54]

The Governor, Gordon Richardson, informed the Prime Minister that the Bank needed to sell £500 million of gilts within a week to get the monetary targets back on track and that MLR would have to be raised by three percentage points to 17 per

[49] TNA, PREM 19/33, 'Note of a seminar', 18 July 1979; T461/197, 'Indexed gilts', Unwin to Bridgeman, 18 Dec 1979.
[50] Lawson, *The view*, p. 114.
[51] Correspondence with Lord Lawson. Thatcher later referred to index-linked gilts admiringly as 'sleeping policemen', see Hanke and Walters, 'Sleeping', p. 217.
[52] TNA, T386/525, 'The monetary prospect', 5 Nov. 1979.
[53] TNA, PREM 19/34, Lankester to Thatcher, 9 Nov. 1979.
[54] Harmon, *The British*, p. 159.

cent.[55] Thatcher reluctantly agreed to the rise in MLR. In a handwritten comment on a short paper written by the Treasury and the Bank commenting on Pepper's post-mortem on the authorities' tactics in the gilts market, she noted that the authors 'protesteth too much' and 'Gordon Pepper was right'.[56]

The Chancellor, Geoffrey Howe, recognised the need to make significant savings in public expenditure and was supported in this by many members of the Cabinet.[57] A meeting was convened with Ministers from the largest spending departments in December 1979 and Howe outlined that he intended to reduce the PSBR by at least £1 billion in 1980-81 and £2 billion in subsequent years. Thatcher, with a view to reducing public sector pay and improving tax revenues, urged a wide-ranging study to be made by the Treasury and Central Policy Review Staff on the scope for de-indexation of, *inter alia*, wage bargaining, social security benefits, direct and indirect taxation, and public sector pensions, as well as the effect of world oil prices on the RPI.[58] The intention was for the study to be prepared by the end of January 1980 to allow time for Howe to make decisions on public expenditure plans for the Budget. The working group was chaired by Sir Douglas Wass, Permanent Secretary in the Treasury, and is referred to as the 'Wass Group' in the official papers.

The report by the Wass Group was broadly supportive of de-indexation and a move to 'less formality and less rigidity' which, it argued, would not lead to any significant changes in the distribution of income or the allocation of resources. The Wass Group

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[55] TNA, PREM 19/34, 'Note of a meeting', 9 Nov. 1979; 'Note of a meeting', 14 Nov. 1979.
[56] TNA, PREM 19/34, 'The UK gilt-edged market', 22 Nov. 1979.
[57] TNA, CAB 128/66, 'CC (79) 21st conclusions'; TNA, CAB 129/207, 'The economic outlook and public expenditure', C (79) 61, 10 Dec. 1979
[58] TNA, PREM 19/164, 'Minutes of a meeting', 7 Dec 1979.

also examined the indexation of government debt and the report adopted a more positive view on indexed government debt than had earlier Treasury reports. It noted:

> Government debt in fact falls into a rather different category from the other areas examined in this report. The nature of the underlying transaction is different and the arguments about indexation are in consequence affected. Indeed, although there has so far been only a limited application of indexation in this field, there does appear to be a fairly strong *prima facie* case for extending the application to other instruments, and in particular to allow the issue of indexed gilts.[59]

It concluded 'that the Government should actively consider extending the scopeof indexation of Government debt…we do not think this recommendation inconsistent with de-indexation elsewhere'.[60] The drafting of the Wass Group report during January 1980 marked the beginning of the most serious consideration of an index-linked security by the authorities since the early 1970s.

In January 1980, Howe informed Thatcher that he was in discussions with the Governor about the possibility of introducing an index-linked security.[61] Bridgeman informed Middleton that speed was of the essence as Howe 'had it in mind' to announce his intentions to introduce the new instrument in the March 1980 Budget.[62] This timescale was unrealistic as a great deal of work had yet to be undertaken by Bank and Treasury officials before any such announcement could be made. Both

[59] TNA, T386/515, 'De-indexation', para. 49, 11 Feb. 1980.
[60] TNA, T386/515, 'De-indexation', para. 57, 11 Feb. 1980.
[61] TNA PREM 19/177, note by Wiggins, 17 Jan. 1980; BEA 7A133/2, 'Note of a meeting', 17 Jan. 1980; TNA, T386/516, 'Indexed Gilts', Davies to Middleton and Lawson, 18 Dec. 1980.
[62] TNA, T386/515, 'Indexation', Bridgeman to Middleton, 28 Jan. 1980.

institutions only began formally to work together to thoroughly assess the arguments in mid-January 1980.[63]

Bridgeman informed the Governor that it was Lawson who was 'something of an advocate' for indexation of debt issues and it was he who had obtained the interest, if not yet the support, of the Chancellor. Bridgeman commented that Lawson had come to realise that there was 'relatively little mileage to be gained' from MBC and, to achieve the monetary targets, he wanted to focus more on reducing the PSBR and exploring the advantages of indexation.[64] Following a discussion with Lawson, Middleton agreed to put together a paper on indexation in the capital market, which would draw upon the work undertaken by the Wass Group and any separate work done by the Treasury and Bank.[65] This was the most comprehensive paper produced on index-linked gilts to date. The paper discussed, *inter alia*, the main arguments for an index-linked gilt; the form it would take and how – and to whom – it would be marketed; the implications for the rest of the capital market; tax considerations; the impact on the PSBR and money supply; and the external effects such as capital flows, OPEC interest and the effect on the exchange rate.[66] The overall view was that there might be positive effects on PSBR and money supply but there was also a worry that so-called 'money illusion', which had meant that investors had earned – without realising – negative real rates almost since the War, would be dissipated once real interest rates, hitherto invisible, were made explicit by the issuance of index-linked gilts with a real rather than a nominal coupon. Issuing

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[63] BEA OV44/2, 'Indexation' a note for the record drafted by Goodhart, 17 Jan. 1980.
[64] BEA, 7A134/16, 'Bridgeman's talk with the Governor', 23 Jan. 1980.
[65] TNA, T386/515, 'Indexation in the capital markets', Middleton to Bridgeman, 31 Jan. 1980.
[66] TNA, T386/515, 'Indexation in the capital markets', Middleton to Lawson, 8 Feb. 1980.

bonds with a positive real rate of return would thus increase the government's cost of funding.

The paper set out a number of possible ways in which an indexed government bond could be structured, with the IPG (Indexed Principal Gilt) – where the principal was increased in line with the RPI over time and the coupons paid out were a fixed percentage of the real principal value of the bond – the clear favourite over variants such as the Inflation Compensation Gilt (ICG) which compensated for inflation in the interest payment only. However, the IPG, with relatively lower – albeit rising – interest payments and relatively higher principal value meant that IPGs would also be attractive to higher rate tax payers and lose revenue for the government. Ways round this could be to lengthen maturity to 20-25 years, too long a maturity for individuals who would be holding a highly price-volatile (high duration) bond until maturity; wait for an inflation accounting Statement of Standard Accounting Practice (SSAP) to suggest a way forward on taxing real versus nominal income and gains; or restrict sales to gross funds, such as pension funds, who did not pay tax on gilts at all. The report noted that overseas investors also did not pay CGT on gilts and that there might be strong demand from overseas investors, which could push up sterling, especially from OPEC countries keen to increase oil prices in line with inflation and invest in similarly linked financial securities. A handwritten note on the paper reflects the balance of power: 'FCO interest in paying for oil with indexed gilts to encourage OPEC to take oil out of the ground".[67] The paper was discussed in a

[67] In the mid-1970s the OPEC countries had threatened to only take oil out of the ground if inflation protection were offered on financial assets in return. For more discussion, see TNA, T448/37, 'Indexed gilts: derestriction', 21 Aug. 1981.

meeting on 19 February 1980, where Lawson's enthusiasm is evident.[68] It was suggested that a substantial element of the government's long-term debt requirements could be met with indexed bonds (up to £4 billion a year).

Following the meeting in February, a number of different papers were prepared by officials in the Treasury, Bank, Central Statistical Office (CSO) and Inland Revenue which included the characteristics of index-linked gilts (their method of issue and details of the prospectus); the potential effects on financial flows in the domestic economy and on money supply and interest rates; the tax treatment of indexed securities and an econometric paper on the effects of non-resident capital inflows on the exchange rate.[69]

There was by now general acceptance that an IPG was the preferred structure, with twice-yearly interest payments.[70] Index-linked gilts would be issued by auction, with no minimum price set. The auction would be conducted on a uniform price basis, based on the lowest accepted price bid. With such a system, the Bank would know how much could be issued at each price and therefore would be in control of the amount actually issued. Bidders would also not pay more than others if they bid too

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[68] TNA, T386/515, 'Note of a meeting', 19 Feb. 1980. The meeting was held in the presence of HRH Prince of Wales. In correspondence with the authors, Lord Lawson suggested that HRH merely looked in briefly at the meeting (his main recollection was that the Treasury was thoroughly cleaned, not least the toilets, in advance of the visit). Goodhart's note for the record suggests HRH stayed long enough to hear Lawson wish to dethrone the Retail Price Index and commented that it was 'perhaps, a tactless turn of phrase since at that point HRH Prince of Wales was sitting on his left'. See BEA, OA44/2, 'Indexation', Goodhart to McMahon, 20 Feb. 1980.

[69] The Treasury files do not cover the period from May to November 1980 but copies of most of the papers can be found in BEA, 14A80/3.

[70] Bank officials had suggested a range for the coupon of between 1 per cent to 3 per cent and that 2 per cent would allow a market to form, see BEA, OA44/2, 'Index linked government stocks', Carse to Fforde, 28 March 1980.

high. In contrast, under the traditional method for conventional stocks, investors determined how much 'tap' stock to buy at a price set by the Bank, with the Bank having to resort to time-limited special offers to tempt additional buyers.

Significant effort had been expended on trying to exclude non-residents from being able to buy indexed gilts, in order to reduce the risk of a rise in sterling, although an econometric paper estimated that the effect on the exchange rate would be limited.[71] There were in any case likely to be protests from other OECD countries if any foreign resident restrictions were included. There was also concern that the lower coupons which would be payable on indexed gilts would encourage higher rate taxpayers to buy indexed gilts; this might be seen as unfair across the income distribution. Attempts to change the tax system to discourage high rate investors would highlight, it was believed, the existing unfairness of taxing nominal rather than real gains. The issue of the corporate bond market was also referred to. As Middleton commented in his introduction: 'the capital market is dead'.[72] There was no long-term corporate bond market, with equities or short-term finance companies' only sources of capital. If equities were crowded out by indexed bonds, there could be pressure from companies, as there had been in 1974, to issue comparable securities.[73]

[71] BEA, 14A80/3, 'Indexed gilts: note for the record of FST's meeting on Wednesday 21 May', 22 May 1980.

[72] BEA, 14A80/3, 'Indexed Gilts', Middleton to Lawson, 2 May 1980.

[73] In 1974, NM Rothschild & Sons Limited, and SG Warburg had approached Bridgeman in the Treasury, with a view to issuing corporate index linked bonds. Both banks had come up with variations on IPGs to even out the annual interest payments over time and make the principal guaranteed in nominal value terms to prevent a large, unknown liability having to be refinanced on maturity. Informal pressure was brought to bear to stop such issues. See BEA, 5A44/7, 'Index linked securities', Coleby to Chief Cashier and Governors, 17 July 1974 and 'Index-linking: Sir Siegmund Warburg', Unwin to Downey and Bridgeman, 23 Aug. 1974.

The papers were due to be discussed at a meeting with Lawson in May, but the Bank, sensing the enthusiasm of some Treasury officials – and in particular Treasury Ministers – for the introduction of index-linked gilts, sought to establish a 'Bank view'. Kit McMahon, the Deputy Governor, aided by Christopher Dow, the Chief Economist, held a meeting at which they considered some of the technicalities and the wider arguments for and against indexation.[74] On timing, McMahon noted Bank officials were expressing 'much more caution than perhaps only a few months ago' when an early move to indexation had been favoured and that 'many of us appeared to believe that the classical Principle of Unripe Time applies here'. There was a consensus on the size of issue (£3bn to £4bn) and the balance of views favoured the IPG over the ICG, although the latter could not be dismissed. McMahon concluded that his personal view was that 'while we shall probably not move to indexation while the going still looks good, we may easily come to a point where our difficulties of funding and constraints on nominal interest rates lead us in this direction'.[75]

As the Bank had suspected, Lawson expressed his views 'strongly in favour' of index-linked gilts at the meeting on 21 May. Charles Goodhart, Chief Adviser in the Bank, attributes Lawson's enthusiasm to his friend, Samuel Brittan, assistant editor at the *Financial Times*, who had argued that introducing index-linked gilts would show the government's commitment to reducing inflation.[76] Goodhart's note of the meeting suggests it was more a question of when – and not if – an index-linked gilt

[74] BEA, 14A80/3, 'Indexed Gilts', Dow to Deputy Governor, 13 May 1980.
[75] BEA, 14A80/3, 'Indexed Gilts', McMahon to Governor, 15 May 1980.
[76] Brittan had argued the case for index-linking prior to 1979, for example, see 'New thoughts on indexed bonds', *Financial Times*, 24 Aug. 1977 and 'Where the economy goes from here', *Financial Times*, 22 Nov. 1979. Anthony Harris was another influential commentator in the 1970s who argued for index-linking, see for example, 'The growing case for indexed government borrowing', *Financial Times*, 13 Nov. 1976.

would be introduced and the purpose of the meeting was to clarify, simplify and reach agreement before Lawson made a recommendation to the Chancellor about proceeding. There was consensus that indexation could only be introduced when monetary growth was seen to be under control but less agreement whether this should take place when the RPI was falling and there was pay restraint (the argument advanced by Eddie George, the Bank's Assistant Director of the Gilt-Edged Division) or whether this was irrelevant, which was the position taken by Middleton. Lawson did not favour restricting the sale of index-linked gilts to domestic purchasers only but, if the non-resident inflows were too strong, then they should be issued to authorised UK pension funds only. Although there were no representatives from either the external side of the Treasury or the Bank, officials pointed out that the short-run effects on the exchange rate could be quite considerable, despite Lawson taking comfort from the econometric simulations which suggested only a modest impact.[77]

The stage was now set for Lawson to write to Howe to recommend a meeting at which a decision could be made and communicated to the Prime Minister.[78] Lawson's letter summarised succinctly the key advantages and disadvantages including cost savings (if inflation fell more than anticipated by the market); slight easing of monetary control; and a 'presentational gain' from PSBR being reduced by around £500 million from a £4 billion issue. Although Lawson was keen to press ahead with issuing an index-linked gilt, there remained some considerable problems. The two key disadvantages were the negative effects on the corporate sector from

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[77] BEA, 14A80/3, 'Indexed gilts: note for the record of FST's meeting on Wednesday 21 May', 22 May 1980.
[78] BEA, 7A133/2, 'Index-linked gilts', Lawson to Howe, 30 June 1980.

indexed bonds competing with equities and on the exchange rate from 'excessive' demand from overseas buyers. For the former, Lawson suggested following the recommendation of the Wilson Committee and removing the fiscal impediment to index-linked borrowing by companies. For the latter, Lawson recognised that EEC and OECD countries might well see the UK as having 'broken ranks' which might lead to pressure from OPEC to thereafter seek 'an inflation-proofed home for their oil surpluses everywhere'. He dismissed this problem, arguing that the French had long offered gold bonds and referred to the econometric paper as showing a relatively slight impact on the exchange rate. Since there appeared no 'foolproof' way of 'preventing purchases of a full-blooded indexed gilt, the issuance of non-marketable indexed gilts to pension funds only was a 'half-way house … very much a second best course'.[79]

Bank officials were largely unanimous that Lawson had not given significant thought to the complications which would arise from issuing index-linked gilts, both in terms of their effects on the upward movement in the exchange rate and the reaction of other countries.[80] Ken Couzens, the Second Permanent Secretary in the Treasury in charge of overseas finance, was also unconvinced by the models which had shown limited effects on the exchange rate. He suggested that, as the UK economy was already experiencing a high exchange rate, any additional rise would be an 'own goal' and attract further criticism. Couzens believed that the UK would cause irritation to other countries if they were to give oil exporters an indexed asset

[79] In practice, the first index-linked gilts were marketable amongst eligible holders only. See TNA, T448/37, 'Index-linked and foreign currency bonds', Middleton to Lawson, 11 Sep. 1981.
[80] BEA, 7A133/2, 'Indexed Gilts', McMahon to Governor, 11 July 1980. Also see Goodhart, 'The Bank', pp. 85-86.

‘gratuitously’ and was dismissive of other countries’ attempts at indexation more generally. He echoed the criticisms that he had made in March when he had stated that ‘I simply don’t like indexation and when the Government starts being wiser than the market and taking bets on its own wisdom it is more likely to lose than gain’.[81]

As Lawson recognised, official opinion was also divided. The Bank’s definitive position was not clear; Howe’s support thus far was lukewarm and Thatcher had yet to be convinced. To persuade Howe of the merits of the argument, Lawson convened a meeting on 17 July 1980 to which the Governor, senior Bank and Treasury officials (both domestic and external) and representatives from the Inland Revenue and CSO were invited. More divisions became apparent at the meeting.

Lawson argued that the conclusions of the Wass Group report about index-linked gilts were robust but, at the meeting, Sir Douglas Wass argued that the disadvantages of index-linked gilts outweighed the advantages. Sir Anthony Rawlinson, Second Permanent Secretary in the Treasury, drew attention to the adverse psychological link to wage indexation and feared that, by issuing gilts, the Government would send out a message that they were worried about funding the PSBR in future. Bridgeman did not offer much support for the idea and, of the other Treasury officials whose views are recorded, it seems that only Ian Byatt, Deputy Chief Economic Adviser and Terry Burns, Chief Economic Adviser to the Treasury, were supportive of Lawson.

The Bank’s contribution was interesting. Kit McMahon was supportive but the

[81] BEA, 7A133/2, ‘Index Linked Gilts’, Couzens to Howe, 15 July 1980; TNA, T386/515, ‘Indexed Gilts’, Couzens to Peretz, 18 March 1980.

Governor, was against the potential new instrument. The Governor said that, after starting off wanting to issue index-linked gilts to strengthen monetary control, he now favoured sourcing additional funding directly from the personal sector rather than issuing marketable securities. He had concluded that the 'balance of advantage' was firmly against the issue of index-linked gilts for a number of reasons. First, he did not accept the currency impact estimates; secondly, he was concerned that Britain would face strong criticisms from other OECD members for allowing oil producers what they wanted; thirdly, repeating the Bank's usual refrain, he did not think other countries had had good experiences of index-linked debt; and finally, he believed the corporate sector would be harmed since indexed gilts were a closer substitute for equities than for debentures.

The Chancellor, who had opened the meeting with the call that the 'burden of proof rested on those who wanted to issue index-linked gilts', did not appear convinced by the end of the discussions. A smaller group of Treasury officials met with the Chancellor on 25 July. The Chancellor ruled out introducing index-linked gilts at this stage but, seeing merit in the argument, suggested that the focus of subsequent work should be on index-linked debt confined to pension funds only. This would side step the issue of inflows into sterling. It was therefore at this meeting that the decision was effectively made to restrict the issue of indexed gilts.[82]

III

[82] BEA, 14A80/3, 'Note of a meeting', 31 July 1980; TNA, T450/24, 'Indexed gilts: derestriction', Peretz to Davies, 5 Aug. 1981.

During the late summer and early autumn of 1980, officials from the Bank and Treasury drafted a number of papers outlining a scheme for a restricted indexed gilt. Initially this was referred to as NOMIS (a non-marketable indexed security) but became known as a RIG (restricted indexed gilt).[83] Under this arrangement, eligibility would be confined to self-administered pension funds and the pensions business of life insurance companies.[84] It was hoped that this would address many of the concerns raised in the meetings in July, including the risk of a sharp upward movement of the exchange rate; avoiding complaints from the OECD that the UK was conceding to OPEC demands for an indexed security; and mitigating tax losses from the tax advantages that an indexed gilt would have for higher rate taxpayers .

The Prime Minister held meetings on 13 October and 18 November 1980 where index-linked gilts were considered.[85] At the first meeting with Treasury Ministers, Treasury and Bank officials, Thatcher made clear her displeasure with the apparent loss of control of the monetary aggregates over the summer months. Howe outlined the steps he intended to take to address this, including further work on a restricted indexed gilt and Thatcher acquiesced.[86]

Before the second meeting with Thatcher, Lawson held another meeting with officials from the Treasury, Bank and Inland Revenue. This considered the Bank's draft of the

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[83] BEA, 14A80/3, 'Non-marketable indexed security', Williams to Riley, 21 Aug. 1980 and subsequent paper.

[84] BEA, 14A80/3, 'Indexed debt restricted to the long term institutions', Williams to Riley, 28 Aug. 1980 and subsequent paper.

[85] The Prime Minister received a copy of a summary paper on restricted indexed gilts, one part of which was described as 'far too gloomy' by Lawson; see PREM 19/179, 'Restricted indexed gilts' which can be found as appendix B to 'Monetary policy: rolling over the target' n.d.; BEA, 7A174/6, 'The monetary roll-over', Westwater to Monck, 9 Oct. 1980.

[86] TNA, PREM 19/179, 'Note of a meeting', 14 Oct 1980.

prospectus and included a discussion on the amount to be issued (an initial issue of £1bn followed by a second tranche of £2bn if the first issue was favourably received); eligibility criteria (life insurance firms should be allowed to hold RIGs) as well as tax issues and the coupon (Lawson agreed that the coupon would be 2 per cent in real terms, with the payable amount based on the adjusted capital value of the bond which would be indexed).[87] Lawson felt that significant progress had been made by officials and was now anxious that everything should be in place to persuade Thatcher that she should approve the issuance of index-linked gilts.[88]

Yet, even if Lawson had brought more Treasury officials around to his way of thinking, there were still two obstacles before he could get final approval to proceed from the Prime Minister. First, Lawson still had to convince Howe that issuing a RIG was feasible.[89] The second, and more technical issue to overcome, was the eligibility issue. George had told Monck that the Bank was reasonably confident that they could police with 'some semblance of credibility' a RIG scheme which applied to the pension business of life insurance companies and to pension funds.[90] This involved a statutory declaration that RIGs would only be bought by life insurance offices for their pension business, with spot checks to be made on their balance sheets to check that they were complying. Yet concerns remained that the insurance companies who ran mixed life and pension funds might argue that restricting the holding of RIG against pension business liabilities might infringe the rights of other

[87] TNA, T386/516, 'Note of a meeting', 4 Nov. 1980.
[88] TNA, T386/516, 'Restricted indexed gilts', Davies to Monck and Howe, 5 Nov. 1980.
[89] Howe's reluctance to move quickly can be seen, for example, in BEA, 7A133/2, 'Monetary control: the November statement', note of a meeting, 14 Nov. 1980.
[90] BEA, 14A80/4, George to Monck, 31 Oct. 1980.

classes of policy holders.[91]

In early November, Lawson wrote to both Sir Keith Joseph, the Secretary of State for Industry and John Nott, the Secretary of State for Trade, to ask for their views on the eligibility question. Joseph was supportive and also wished to convert existing long-dated high coupon gilts to index-linked stock (which the Treasury intended to examine after the RIG was issued).[92] Nott was not supportive: 'How, he argued, could the Government justify indexing payments to its creditors and not to its employees? There was talk of thin edge of wedges'.[93]

Although the economists in the Department of Trade managed to persuade Nott on the merits of RIGs *per se*, the issue of eligibility de-railed Lawson's attempt to persuade the Prime Minister to proceed with agreeing to issue a RIG at the monetary seminar on 18 November 1980. More work was deemed necessary and the Prime Minister asked Lawson to prepare a short paper on the advantages and disadvantages of index-linked gilts and to respond to Nott's criticisms.[94]

On 13 January 1981, under a cover letter requesting the Prime Minister to make an 'early decision', Lawson drew on key phrases from the Wass Group's report; the arguments which had been advanced by officials during the course of 1980; and the recommendation from an inquiry by Sir Bernard Scott, which argued that the government should look seriously at the case for issuing indexed bonds to cover

[91] TNA, T386/516, 'Note of a meeting, 4 Nov. 1980.
[92] TNA, T386/516, 'Restricted indexed gilts', Davies to Riley, Monck and Lawson, 17 Nov. 1980; 'Restricted indexed gilts', Lawson to Nott, 6 Nov. 1980.
[93] TNA, T386/516, 'RIGs', Davies to Monck, 13 Nov. 1980.
[94] TNA, T386/516, 'Restricted indexed gilts (RIGs)', Nott to Lawson and the enclosure, 17 Nov. 1980; PREM 19/180, 'Note of a meeting,' 20 Nov. 1980.

pension liabilities in the public sector.[95] The Prime Minister's newly appointed personal economic adviser, Alan Walters, was supportive of Lawson's argument, and commented that, as index-linked gilts would have to be issued by tender auction, this in turn would 'facilitate more rapid movement towards MBC'.[96] He suggested that if £10bn of the £20bn of total borrowing were indexed, it would remove £1.2bn from the PSBR in the current year, although the Treasury disputed this figure.[97] The Prime Minister wrote on Walters' note that an 'urgent' meeting was needed to be held with the Chancellor and Governor. Over the next fortnight, events moved quickly.

The Chancellor held a meeting with senior Treasury officials to discuss Lawson's letter to the Prime Minister on 21 January and with senior Bank and Treasury officials on 23 January.[98] The Governor adopted a more negative tone than he had done during the meeting in July 1980, and even the Deputy Governor, who conceded the technical arguments for issuing index-linked gilts, was not in favour. McMahon questioned whether the risks associated with this 'very radical innovation' were outweighed by the 'modest improvement' in monetary control which the government hoped for. At the meeting on 23 January, Howe and Lawson appeared more aligned, although Howe considered that there remained a large number of

[95] TNA, PREM 19/440, 'Indexed gilt-edged stocks', Lawson to Thatcher, 13 Jan. 1981. The report was released to Ministers on 19 December 1980 and was published in February 1981. See *Inquiry into the value of pensions*, British Parliamentary Papers 1981, Cmnd. 8147, paras. 28, 116-119.
[96] TNA, PREM 19/440, 'Index gilts', Walters to Thatcher, 15 Jan. 1981; PREM 19/439, 'Indexed gilts', Walters to Thatcher, 19 Feb. 1981. Pepper and Walters also believed that tender auctions would enable a firmer quantitative grip over the time-path of public sector debt sales.
[97] TNA, T386/616, 'Indexed gilts', Middleton to Walters, 27 Jan. 1981.
[98] TNA, T386/616, 'Note of a meeting', 21 Jan. 1981.

practical problems if the government did press ahead.[99] Howe's worries about issuing an indexed security partly reflected the reaction of the Cabinet to the Scott inquiry recommendation to issue index-linked bonds to hedge public-sector pension liabilities, a number of Ministers arguing that indexation would accommodate inflation (the annual increase in the RPI had fallen from a peak of 18 per cent for 1980).[100]

The decision to issue an index-linked gilt received Prime Ministerial approval at the meeting on 27 January 1981.[101] At that day's meeting, Lawson admitted that he had some anxieties about how the market would react to the introduction of the index-linked gilt and stated that if he could get a 'firm undertaking' from the Governor, to improve existing gilt sales by new marketing methods, he would not push for a RIG. The Governor opposed auctions for conventional gilts for fear of disrupting the market, so the only immediate solution, which appealed to the Prime Minister, was the introduction of an alternative instrument which, whilst helping with the funding problem and reducing interest costs, would also allow the use of the new auction method.[102] Having received the consent of the Prime Minister to proceed, Lawson argued that the security should be introduced immediately but Andrew Turnbull, an assistant secretary in the Treasury, reported back to Thatcher that the introduction

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[99] TNA, T386/616, 'Note of a meeting', 23 Jan. 1981; TNA, T386/616, Ridley to Howe, 23 Jan. 1981; 'Index Gilts', Wiggins to Ridley, 26 Jan. 1981

[100] TNA, CAB 128/70, 'CC (81) 2nd conclusions', 15 Jan. 1981; CAB 129/211, memorandum by Chancellor of the Exchequer and the Lord President of the Council, 'Inflation-proofed pensions', C (81) 3, 9 Jan. 1981.

[101] TNA, PREM 19/440, 'Note for the record', 27 Jan. 1981. Thatcher repeated an earlier request for the security not to be known as a RIG and several new sobriquets had already been discussed including New Indexed Gilts (Eligibility Limited) and Pension Indexed Gilts but given their acronyms they were dropped in favour of Indexed Gilt-Edged Stocks. See T386/515, 'Restricted indexed gilts (RIGs)', Davies to Riley and Lawson, 28. Nov. 1980; 'Indexed gilt-edged stock', Carse to Davies, 18 Dec. 1980.

[102] TNA, PREM 19/440, 'Note for the record', 27 Jan. 1981; 'Note of a meeting', Lankester to Wiggins, 29 Jan. 1981.

should be delayed until the Budget in March, 'as there was some danger of appearing to be acting out of desperation'.[103] Lawson disagreed with this assessment, but, with some issues still to be finalised, the Chancellor decided to make the announcement in the Budget, scheduled for the 10 March.[104]

IV

The first index-linked gilt issue was made on 27 March 1981 with a maturity of fifteen years and a real coupon of 2 per cent.[105] Both coupon and principal were linked to the RPI. Interestingly, officials never discussed the choice of index at length. In early February 1980, officials in the Treasury, Bank and Revenue had concluded that:

> In practice there is not much choice of index. The RPI is the only real possibility. It is well established, not subject to revision and its definition cannot be changed at the whim of the Government…The alternative of the GDP deflator is unsatisfactory: it is esoteric, not well understood and is subject to periodic and substantial revision by the CSO. [106]

The issue was oversubscribed and the £1bn issue was sold at a clearing price of par (£100). The eligibility criteria restricted the purchase to pension funds and the pension business of life insurance companies and were extended, just before the final prospectus was issued, to the pension business of friendly societies. The thorny

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[103] TNA, T386/616, 'Indexed gilts', Turnbull to Howe and Wass, 27 Jan. 1981.
[104] TNA, T386/616, 'Indexed Gilts', Davies to Monck, 4 Feb. 1981; PREM 19/440, 'Indexed gilts', Howe to Thatcher, 18 Feb. 1981.
[105] Early assumptions had assumed a maturity in excess of 15 years, see TNA, T386/515, 'Index linked gilts', Bell to Britton, 3 March 1980.
[106] TNA, T386/515, 'Indexation in the capital markets', Middleton to Lawson, 8 Feb. 1980. Lawson agreed to use the RPI at a meeting on 19 February 1980, see TNA, T386/515, 'Note of a meeting', 19 Feb. 1980.

issue of the tax status of indexed gilts was dealt with by confining the purchase of indexed gilts to tax-exempt funds and there was no specific mention of CGT in the prospectus.[107]

The issue was viewed as having achieved its objective with 2,795 tenders analysed for a total of £1.6b and an average tender amount of £568,840. However, the prices bid were within a wide range of £80 to £200, with 83 per cent of the bids between £95 and £114.75. Bidders could make very high bids, secure in the knowledge they would pay only the lowest accepted bid price. Table 3 gives the range of allotments in more detail.

** Table 3 here **

The wide price range and the fact that many sophisticated issuers made several differently priced bids – for example, Eagle Star with bids at £104 to £116 at £4 intervals – showed a lack of knowledge of what the real rate of interest should be and hence how much to pay for a 2 per cent real rate of return.[108] George, reporting to Turnbull on the issue, referred to rumours of a boycott of the issue by pension funds, told by their actuaries that 2 per cent was not high enough, but pointed out that the tender data did not support this. There was no evidence of any abstentions and the unweighted and weighted average bid prices were £105 and £101.25, both above par.

[107] TNA, T386/617, 'Indexed gilts: letter from Grieveson Grant', Davies to Middleton, 18 Feb. 1981.
[108] TNA, T448/36, George to Turnbull, 24 April 1981.

V

The introduction of index-linked gilts in the United Kingdom is a hitherto untold story of many twists and turns. Up to the late 1970s, both Treasury and Bank officials had proffered a litany of arguments against indexation. With the high inflation of the 1970s destroying the long-term capital market for fixed-interest debt, growing difficulties associated with managing the gilt-edged market and the move to money supply targets, many of the well-rehearsed arguments of the 1950s and 1960s began to be challenged. On the grounds of inflation, the arguments for the introduction of indexation may have been stronger during the 1970s than in the early 1980s, but political enthusiasm for indexation ebbed and flowed among Treasury Ministers until Nigel Lawson gave serious consideration to indexation from 1980.[109]

As we have shown, Lawson faced a difficult task in convincing some members of the Cabinet, including the Chancellor and the Prime Minister, of the benefits of index-linked gilts, although the Prime Minister recognised that in the short term, there was the need to finance the PSBR, and the launching of this new product would make future gilts strikes less likely.[110] Lawson successfully persuaded the Prime Minister that index-linked gilts would not embed inflation into the economic system; would enable a greater degree of monetary control; and would mark the beginning of

[109] The RPI was 21.9 per cent in May 1980, before dropping to 16.9 per cent in July 1980 and 12 per cent in April 1981.
[110] Alan Walters notes in a diary entry that even eight months after index-linked gilts were issued, Geoffrey Howe (GH) was 'lambasted by PM about interest rates and indexed gilts. GH still does not want to issue indexed gilts'. See CAC, WTRS 3/1/1, 9 Dec. 1981.

tender auctions.[111] Coupled with lower debt servicing costs and a consequent reduction in PSBR, this held out the hope of eventual cuts in taxation.[112]

The speed with which Lawson pushed through this new financial instrument at the start of the 1980s showed the strong influence he had on the government's economic policy, even before he became Chancellor in 1983.[113] Lawson had support from some key officials, although a few Treasury officials and a significant number in the Bank saw little merit in the new instrument. Despite the fears and endless worries about the downside risks, the majority Treasury view won out over that of the Bank.[114]

The first issue was fully subscribed at par and the coupon tallied with long-term real wage increases, the indexation measure of RPI was generally accepted as the primary measure for inflation and the tender auction system had generated higher prices than the traditional tap method.[115] When they were initially introduced in March 1981, index-linked gilts were restricted to UK pension funds which reduced the risk that there would be significant sterling inflows. This also got around the issue of CGT as UK pension funds were tax exempt.

Some of the arguments of the early 1950s to the 1970s were rehearsed as officials

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111 Correspondence with Lord Lawson.
112 Moore, *Margaret Thatcher*, p. 504.
113 Tomlinson, 'Mrs Thatcher's', p. 11.
114 Thatcher had a difficult relationship with the Governor during this period exacerbated by his non-acceptance of the case for MBC. See Lankester, 'The 1981 Budget', p. 13.
115 As a substantial amount of bonds remained unsold on several occasions, single price auctions were abandoned in the decade after 1988 and instead index-linked gilts were issued entirely by tap.

looked at indexation between 1979 and 1981, but there were also new problems to consider such as OPEC interest and the effect on the exchange rate. These deliberations were undertaken with a far more technical perspective than they had been in the early 1970s and were particularly intense period between January 1980 and January 1981. As Adam Ridley, a special adviser to the Chancellor in 1981, later noted, in terms of structure and issue method their innovation 'marked a new and adventurous phase in the techniques of monetary policy and debt management'.[116]

Following the favourable reaction to the first issue, officials turned their attention to relax the eligibility restrictions and, from March 1982, the restrictions on the ownership of index-linked gilts were removed.[117] Discussion on de-restriction proved to be particularly contentious within the Bank, with strong arguments advanced *inter alia*, about the effects on the exchange rate of allowing non-residents access to index-linked gilts; CGT concerns; how it would effect the equity market; and whether it would lead to a clamour for more widespread indexation.[118] These fears were dismissed by some key officials in the Treasury and, in the absence of Nigel Lawson who had left the Treasury in September 1981, by Alan Walters.[119] A full account of de-restriction, and the fundamental changes which were later to come for the gilt-edged market, are part of another story.

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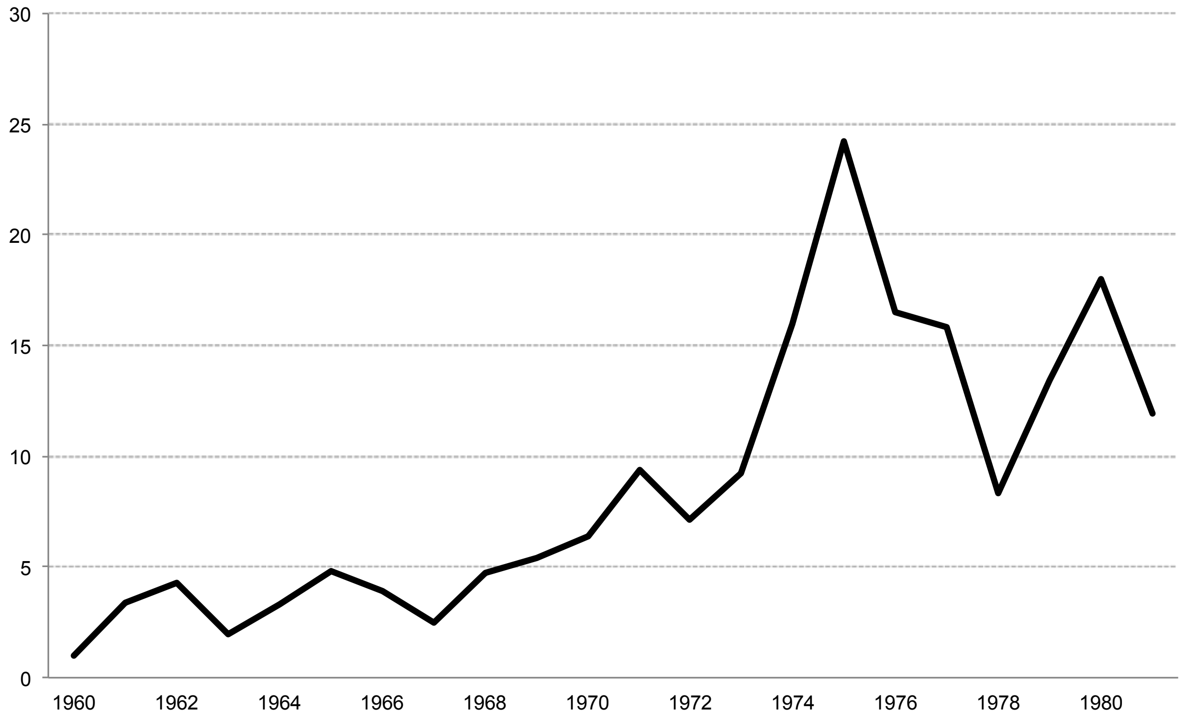
[116] Ridley, 'The 1981 Budget', p. 71.
[117] See for example, 'Bold action to curb public borrowing costs', *Financial Times*, 11 March 1981; 'Money on the mend', *The Economist*, 14 March 1981.
[118] BEA, OA44/3, 'Derestriction of IGs and interest rate policy', Goodhart to Governors, 10 Sep. 1981; 'The pros and cons of derestriction', Dow to Governors, 2 Oct. 1981.
[119] TNA, T472/44, 'Note of a meeting', 21 Sep. 1981; PREM 19/696/42, 'Monetary and funding conditions', Walters to Lankester, 17 Sep. 1981; 'Indexed gilts', Walters to Thatcher, 21 Jan. 1982.

Table 1. *Dates of introduction of indexed bond in various countries*

Date first introduced	*Country*	*Type of indexation*
1780	United States	Consumer prices
1945	Finland	Wholesale prices
1952	Sweden	Consumer prices
1955	Iceland	Consumer prices
1964	Brazil	Wholesale prices
1966	Chile	Consumer prices
1967	Colombia	Wholesale prices
1972	Argentina	Wholesale prices

Notes: Page and Trollope, ‘An international survey’, suggest that the United States introduced indexed government bonds in 1742 but Campbell and Shiller, ‘A scorecard’, cannot find earlier evidence of their introduction than 1780 by the state of Massachusetts. We have followed Campbell and Shiller and only list dates of price-indexed bonds as opposed to those linked to a foreign currency (e.g. Israel in 1948) or the price of a precious metal (e.g. France in 1952).
Sources: Shiller, ‘Invention’, Rutterford, ‘Index-linked gilts’; Campbell and Shiller, ‘A scorecard’.

Figure 1 *Rate of inflation in the UK, 1960-1981 (RPI)*



Source: Office for National Statistics

Table 2 *Importance of gilt-edged stocks (£ million) (year-end March)*

Year	*Public sector borrowing requirement*	*Amount of PSBR funded by:*					
		National Savings		*Gilt-edged stocks*		*Net purchases of all gilts by life assurance companies and superannuation funds*	
			Of which index-linked	*All*	*With maturities of at least 15 yrs*		*Per cent of total gilt issues*
1972	1,600	460	0	-520	890	na	na
1973	2,340	100	0	1,540	750	na	na
1974	3,540	0	0	660	130	200	30
1975	8,390	410	225	5,210	2,750	2,500	48
1976	6,790	590	225	5,400	3,580	2,980	55
1977	4,470	1,290	282	7,290	4,630	3,350	46
1978	8,370	1,530	271	8,050	3,800	3,990	80
1979	10,430	1,060	121	10,150	7,100	4,800	47
1980	11,160	1,380	469	10,690	5,440	4,240	40

Notes: As noted above, index-linked national savings were first issued in 1975.
Source: Rutterford, 'Index-linked', p. 3.

Table 3. *Tenders for 2% index-linked Treasury Stock 1996*

Price (£)	*Number of tenders*	*Per cent of total*	*Amount Tendered (£000's)*	*Per cent of total*
135-200	3	0.1	135	–
130-134.75	5	0.2	1,140	0.1
125-129.75	10	0.4	9,875	0.6
120-124.75	32	1.1	10,835	0.7
115-119.75	199	7.1	109,720	6.9
110-114.74	494	17.7	184,640	11.6
105-109.75	737	26.4	265,755	16.7
100-104.75	799	28.6	424,020	26.7
95-99.75	280	10.0	281,230	17.7
90-94.75	159	5.7	181,760	11.4
85-89.75	65	2.3	108,695	6.8
80-84.75	12	0.4	12,105	0.8
Total	2,795	100.0	2,589,910	100.0

Notes: high price tendered was £200; lowest price tendered was £80; allotment price was £100; mean price was £104.50 (rounded); mean price weighted by size of tender was £101.25 (rounded); modal price was £105; standard deviation of price was £7.75 (rounded); average amount tendered was £568,840 (rounded).

Source: TNA, T448/36, 'Review of 2% index-linked Treasury stock 1996', 24 April 1981

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