SECRET

For 9 am meeting

3.7.79.

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Sir D Wass
Sir L Airey
Sir K Couzens
Sir A Rawlinson
Mr Littler
Mr Hancock
Mr Middleton
Mrs Gilmore
Mr Riley
Mr Culpin

Mr Ridley
Mr Cardona

Mr Fforde
Mr Page

The Governor.

Pl. see p. 9 (para 19)

If (i) fails (ii) is tolerable

(iii) + (iv) are awful

3/7

MORTGAGE RATES AND MLR

The Prime Minister's meeting should have before it:-

i. your minute of 25 June 1979;

ii. a note from the Secretary of State covering two papers by DOE officials on:-

a. the current financial position of the building societies;

b. the possible ways of providing financial assistance to them to avoid an increase in their interest rates.

(a. and b. were cleared with us in draft and are attached - we have not yet seen the covering letter.)

2. This submission first assesses the options open to the Government. It then suggests some points which you may wish to draw on when speaking at the meeting.

Assessment

a. Building Societies

3. The ordinary share rate offered to building society investors is now some 2½% below the local authority 3 month rate which they normally use as a yardstick for the competition. Some ½% is due to the effect of the change in the standard rate of tax, and most of this drop could be made good without changing the mortgage rate. But any further increase in the "grossed up" share rate to make them less uncompetitive would have to be matched very nearly one for one by an increase in the mortgage rate.

4. The inflow into building societies in June was badly affected by the post-Budget spending rush, with the larger societies having net withdrawals for two weeks. Both the BSA and we would expect the net inflow into societies to return to about £200 million a month if they did not raise their interest rates and if other market rates did not fall very much. This compares with the £350 million a month net inflow which they require to maintain the recent gross lending level of about £750 million a month. It is not possible to be precise how far, if they did not put up their rates, they would run down their liquidity, which is now on average on the low side, and how far they would cut back on their lending: the reaction would vary significantly from society to society, depending both on their current liquidity level and on the general attitude of management.

5. Our impression is that the majority of societies are now coming to the view that they ought to move their rates this month, rather than wait until September, a view which has been gaining ground since it has become apparent that short term interest rates may stay fairly close to their current levels for some time to come. In ten days time, when they take the decision, they will have figures for the inflow to the 12 largest societies for two more weeks, so they will be able to see how it has recovered after the spending boom. (The next figure will become available at about lunchtime on Wednesday, and we will let you

know its import before the Prime Minister's meeting.) They will also be influenced by the reaction of commentators and the money markets to the announcement of the eligible liabilities and clearing banks figures next Tuesday.

6. Subject to those developments, our best expectation is still that societies if they move would move the mortgage rate to somewhere between 12¾% and 13½%, with the probability being that it would towards the higher end of that range.

b. Monetary Policy and Housing Policy

7. Treasury and DOE officials are agreed that, looked at in relation to either monetary policy or housing policy, the balance of advantage lies with building societies moving now rather than in September. In particular:-

i. for as long as the target is for £M3, there is advantage in societies offering interest rates which attract funds away from the banking system - the present situation with some banks offering more on ordinary deposits than the "grossed up" building society share rate is most unusual;

ii. to the extent that the low level of inflow causes the building societies to run their liquidity they will be reducing their holdings of public sector debt and this will have a depressing effect on the short end of the gilts market;

iii. to the extent that they cut back on their lending, this could further depress the present low level of housing starts.

8. The one factor pointing the other way is that house prices still seem to be growing at a rate of 25%-30% per annum, and a cut back in

building society lending levels might reduce that rate, although probably with a lag.

c. Expedients

9. The DOE paper annexed, "Alternatives to Increases in the BSA Recommended Mortgage Rate", reviews briefly six (or rather eight) possible alternatives to an increase in the recommended mortgage rate. Four of these involve certain or contingent public expenditure, namely an interest rate subsidy (on the lines of the Conservative administration's bridging grant of 1973), persuading societies to operate at a loss, with an Exchequer guarantee, a short term Government loan (on the lines of the Labour administration scheme in 1974) and persuading societies to make greater use of their liquidity, underwritten by some form of government guarantee which could be converted into a loan if necessary. A fifth, adjusting the composite tax rate, is also a form of subsidy which will add to the PSBR. It has the presentational advantage of not adding to public expenditure, to be set against the grave disadvantage that it would completely upset the present basis of the composite rate system, namely that it is a "revenue neutral" averaging out process between different building society investors: this would raise the whole question of "fiscal neutrality" between different types of financial institutions and it is very questionable whether one wants to use the tax system as a means of giving short term advantages.

10. All five suffer from the grave disadvantage, to which you drew attention in your minute, of undermining the Government's credibility in relation to its commitment to hold down the PSBR, and so to its commitment to monetary targets. Moreover, all these courses would effectively be an open ended commitment. We cannot be certain when interest rates would come down to a level at which the assistance could be phased out and then ended. Indeed, the financial forecast would indicate that they might not only have to be continued through this year but well into next. Moreover, the very act of Government weakening its credibility in this area, could of itself lead to higher market

interest rates, which would mean that the rate of assistance would have to be increased.

11. Two of the expedients involve persuading the societies to tap additional sources of funds, either the short term domestic money markets, or the euromarkets. It is very doubtful whether societies generally would be ready to go down either of these roads at this time, although it is just possible that a few societies might just take the former. The idea of the building societies tapping the short term money markets has been discussed with them from time to time and they have generally been resistant to it, partly on "doctrinal" grounds and partly on practical ones. Some, but not all, in the building society movement see objections in offering higher rates of interest to non-members than the interest rate paid to members on their shares. But societies generally see two main difficulties. The first is that they could well find that they were merely obtaining some of the funds which they have at present at a higher interest rate, because the individuals concerned were to switch from lending to them direct to lending through the money markets. The second is that they would be concerned at borrowing at higher interest rates, as they would be faced at the time of roll-over of the loans, say in 3 months time, with the fact that they could only borrow at even higher rates, because market rates had moved against them in the meantime: they would only think it a prudent and expedient to borrow in this way if there was a strong chance that interest rates would be lower in 3 months time, and very little chance that they would be higher. They do not have that certainty at present.

12. Quite apart from the exchange control complication, we would be very doubtful whether societies would be prepared to borrow on the Euromarkets which would be a completely new area for all of them. Moreover, on prudential grounds they could not borrow without forward cover of the repayment, and this would bring the rate of interest payable up to domestic rates. Therefore, they would almost certainly prefer the domestic market option to the euro-dollar one.

d. Persuading the Societies to Delay

13. The one option which avoids most of the difficulties inherent in the other seven, would be to persuade the building society leaders to delay a decision on interest rates until September. We think that there probably is sufficient division of view within the building societies, for the Council to be swayed at that meeting at a request from Ministers to defer a decision until September. This would have to be put to them on the basis that neither they nor we can be certain about the course of interest rates over the next few months, but they might be in a better position to decide how much they needed to adjust their rates in September: it would seem unfortunate for building societies to move up their interest rates to record levels, when there was a possibility that it might appear by September that a smaller move would have sufficed. If societies are to be persuaded by this approach, they would almost certainly need a very specific assurance from Ministers that they will be allowed to adjust their rates in September to whatever rate may then appear necessary. They would point out that it would reduce their ability to finance council house sales in the meantime. They may also point out that the obverse of delaying an increase would be the need to rebuild liquidity when building societies were next at an advantage, and so delaying the subsequent reduction in rates. It would be very important for the future credibility of Ministers in their relations with the building society movement that the proposition should not be put to them on the basis that interest rates will necessarily be lower in September, but only that there is a chance that it will be lower.

14. If this approach were adopted, Ministers would have to leave it to societies how much they adjusted to the situation in the meantime by reducing lending levels, and how much by running down liquidity. Ministers might indicate a preference for the former (although that would not help with monetary policy) but would have to say that they recognised that the liquidity position of different societies was different, and that each society would have to decide what was prudent in its own circumstances.

15. This option is not, for the reasons indicated in paragraphs 7 and 8 above one which we would recommend in relation to either monetary policy or house policy. Moreover, it is arguable that it would be

preferable for the next wage round if any increase in the mortgage rate could have been got over sooner rather than later. It also runs the risk that the increase decided on in September might prove to be higher than now, even if competing interest rates were not higher, just because societies would be getting more apprehensive about their liquidity levels, having run down liquidity to some extent in the meantime. But it would seem a preferable course to any of the other expedients.

e. Minimum Lending Rate

16. There are strong arguments on the grounds of monetary policy for not reducing MLR this week or next week, and it is very doubtful whether doing so now would have much effect on the decision by building societies.

17. The main monetary arguments against a change are:-

i. the present level of interest rates has not been in operation for a sufficient period yet to have had an effect on lending levels, the main immediate reason for raising MLR. The provisional outturn figures for June show bank lending of some £800 million, which is higher than we had expected. The July figure will almost certainly be swollen by the effects of the post-Budget surge in spending, and it may be August before we can start to see a down turn.

Acceptances leak.

ii. to reduce MLR ahead of evidence that it was working in relation to bank lending runs the risk that it may be necessary to increase it again later. If that had to be done it might well have to be to an even higher level than now.

iii. a move of MLR down now ahead of the market, and in the absence of reassuring figures for bank lending,

would look rather odvious in relation to the timing of the building societies' decision. It would lead to the markets speculating that the Government lacked the conviction to carry through its monetary policy. Such conviction is critical at this stage: one of the main effects of a tight monetary policy is intended to be on inflationary expectations, and those will only beeffective for as long as people are convinced that the Government will hold to those targets. (This point is developed further in speaking notes below.)

iv. technically MLR cannot be used to lead market interest rates down. This is because it is the penalty rate at which the Discount Market can borrow from the Bank. MLR can therefore be used to raise market interest rates. It can also be used to confirm a fall in market rates - if it is moved down following the market, it is treated as a signal that the authorities are content with that lower level. But to lower it ahead of the market just makes it inoperative as a penalty rate.

18. Building societies are not directly affected by MLR as such, but by competitive interest rates. They are therefore only interested in MLR insofar as it affects other interest rates. So a reduction in MLR ahead of the market would probably have little effect on their decision: indeed they, like others, might be worried if it signified a weakening of the Government's resolve to deal with inflation through monetary policy. If market rates were to drift down over the next week, which is possible but not likely, then they might be affected if that downward movement was confirmed by a downward adjustment in MLR. But that is the only circumstance in which a change in MLR would be likely to affect their decision.

19. From the point of view of the Government's economic and housing objectives, we would rank the alternatives in order of preference:-

i. allow the building societies to adjust their rates as they think fit (subject of course to their not raising interest rates to a level which would actually lead other market rates - we think this unlikely);

ii. to seek to persuade building societies to delay any change until September;

iii. to reduce MLR;

iv. to adopt one of the subsidy expedients.

The choice between iii. and iv. is a fine one: both are objectionable on grounds that they damange the Government's credibility and while iii. may do less damage than iv. it would probably have little effect on the building societies - in terms of cost/effectiveness there is not much to choose between them.

Effect on Borrowers

20. I understand that you asked at the meeting on Monday about the effect of an increase in the mortgage rate on borrowers. We have not, for obvious reasons, consulted the BSA about this, but our impression is that societies are tending more and more to let the presumption be in favour of adjusting the payments for increases in interest rates, rather than letting the period of payment be extended. But they do allow the borrower to ask for the second, provided that the monthly payments are at least covering the interest. If the mortgage rate were increased to say, 13%, the option would be open to borrowers who had either:-

a. taken out their mortgage at the current rate of 11¾%;

or b. had increased their payments recently, to be in line with that interest rate;

or c. had either taken out mortgages at the earlier peak of 12¼%, or had adjusted their mortgage payments to that rate at that time, and who had subsequently opted not to reduce their monthly payments when the interest rates fell.

The option would not however be available to those whose current payments had originally been determined in relation to an interest rate significantly below 11¾%.

21. You also enquired about what this would mean for past borrowers in relation to their increased incomes. Annex 3, which was prepared by Mr Pickford, takes the two extreme cases. Those who either took out their mortgage at the last peak or had their rate of repayment calculated on the basis of that level, would be faced with an 8% higher rate of annual repayment, but their income would have increased by about 40% since then and the value of their house as an asset by over 60%. At the other extreme would be people who took out mortgages a year ago when the mortgage rate was 8½%. Their repayments net of tax would have increased by 43%, but their income by only some 17%, and the value of the house by some 30%. Most borrowers will fall somewhere between the two extremes.

Speaking Points

22. You might like to draw on the following points during the discussion at the Prime Minister's meeting:-

i. the Government is committed to a tight monetary and fiscal policy as the method of combating inflation, and this necessarily means a squeeze on the economy.

The public expenditure cuts will help in time to bring about a lower rate of interest rates. But it will be necessary to use interest rates to achieve the tight monetary targets. To the extent that one sector is sheltered from the effect of those interest rates, other sectors of the economy will have to be squeezed more.

ii. the Government has gained general approval for its tough monetary policy. But the extent to which the economy will be forced into recession, before monetary policy affects the rate of inflation, would depend critically on the speed with which monetary policy affects inflationary expectations in the economy. It is therefore critically important that the Government should reinforce and widen the conviction that the Government will carry through its monetary policy until inflation is brought down. In particular, this point has got to be got across to employers and employees. The Government therefore cannot afford to be seen to be lacking conviction in its policy by drawing back from its consequences. In all economies a tight monetary policy inevitably affects the housing market. In the United Kingdom, it may in fact do less than in many others, just because of the tax treatment of owner-occupiers.

iii. it is clearly unfortunate that mortgage interest rates have to go up, given the Government's firm commitment to wider owner-occupation. But it is in the interests of the owner-occupier, as in the interests of everyone else, that the Government's overall monetary policy should succeed in conquering inflation: that would be the only firm basis for a recovery.

iv. even with the increase in the mortgage rate, borrowing for owner-occupation would still be very attractive, given the tax relief. The net cost of a mortgage to a standard rate taxpayer, if the mortgage rate went to 13%, would be 9.1% which is below the expected rate of inflation for the next year or two, and also well below the current rate of increase in house prices.

v. given this, it seems better to allow the building societies to secure the necessary funds for mortgage advances, rather than to shelter home owners from the effects of the tight monetary policy.

vi. the choice is essentially between four courses, to let building societies to go ahead, to seek to postpone their decision until September without the use of gimmicks, to seek to affect their decision by a change in MLR and to seek to affect the decision by offering some form of subsidy.

The third and fourth would both strike at the Government's credibility, and indeed could lead to higher interest rates generally. The second would mean accepting an increase in September, and while one would hope that it might be less than would be the case now, there is no certainty - it could be higher than if they decided now. Indeed, it could mean the increase coming at a time at which the TUC were becoming restive, and so affecting inflationary expectations and interest rates. The first course of letting the building societies take that decision therefore is to be preferred.

J.M.B.

J M BRIDGEMAN
3 July 1979

CONFIDENTIAL

BUILDING SOCIETY MORTGAGE RATES: EFFECT OF BUDGET

1. COMPETING RATES OF INTEREST The basic tax rate reduction has correspondingly reduced the BSA recommended share rate from 11.94% gross to 11.43% gross (8% net). With the increase in MLR from 12% to 14%, and the rise in short-term rates, the competitive differential between the BSA and competing rates is now -2½% (local authority 3 month rate 14%).

2. INFLOW Building societies net inflow has been about £300m a month. The June estimate is between £50m-£150m and societies are facing a temporary net outflow of funds as investors have spent to beat the VAT increase. At best, inflow might level out at about £200m a month given competing rate levels, It is not possible to predict the immediate future for competing interest rate levels: they will not necessarily remain at present levels until the end of the year, but there is no certainty of a significant drop.

3. LENDING AND LIQUIDITY The BSA had wanted to increase lending to over £800m a month and provide about 70,000 loans a month Q3 1979. The Government side had considered this too high because of house price increases. The debate was academic becauase of the fall in inflow and therefore the guideline has been virtually suspended for Q2 and Q3 1979.

4. Societies lent about £720m a month for house purchase in the first 4 months of this year (including £60m a month on peripheral lending for improvements etc). They lent £795m in May. This was possible with some small reduction in liquidity. The figure may be about £760m in June. Loans were running at 60,000 a month January-May. Liquidity is now at 17.6% (seasonally adjusted) on average. Mortgage commitments already made will cause liquidity to fall to 17% in July and at that level societies tend to cut-back on lending.

5. PROSPECTS WITH NO CHANGE IN BSA RECOMMENDED RATE STRUCTURE With inflow down to an estimated £200m a month, lending could fall quite quickly from over £700m to under £600m a month. With an assumed average advance down to a low level of under 60% and with house prices rising at a rate of 25% pa over the next few months the number of loans could fall to 40/45,000 - a level last seen at the end of 1976.

6. POSSIBLE BSA REACTION An increase in the BSA rate structure is almost inevitable if there is no perceived prospect of significant changes in competing rates and no Government intervention. The BSA could go for a hodling increase judged to be sufficient only to ensure that some societies are not faced with the risk of a net outflow. Or they could move up higher to better safeguard their lending rate. Possible alternatives on the reasonably safe assumption that the BSA do not seek to become 'interest rate leaders' by offering 14% or more to investors - include:

	Share rate (gross)	Mortgage rate	Inflow	Loans
Present:	11.43% (8% net)	11.75%	£200m	40/45,000
Alternative 1:	13% (9.1% net)	12.75%/13%	£280m	45/50,000
Alternative 2:	13½% (9.45% net)	13½%	£300m	about 50,000

These figures suggest that the number of loans will fall despite any conceivable mortgage rate increase. The societies will gain some help on their margins from a reduction in their composite tax rate.

7. TIMING. The next meetings of the BSA Council are on 13 July and 14 September; they are preceded by meetings of the Joint Advisory Committee on 5 July and 6 September.

8. Changes in the recommended rate structure require a two thirds majority of the 36 member Council on which the small societies have a representation in excess of their relative importance. Opinion tend to split between the larger and smaller societies with the larger societies being more dovish on rate increases but opinion also varies within the groups especially as between the larger societies. The Council does not meet again until September and therefore the July decision is particularly important for the building society movement. The net outflow shown in the last two weekly June figures could be an important influence.

9. HOUSE PRICES/FIRST TIME PURCHASERS. House prices rose on average by 28% through 1978. They have risen about 11% in the first 5 months of 1979 and are currently rising at about 2½% a month. Because house price statistics reflect bargains struck some months earlier a mortgage rate increase/longer mortgage queue is not likely to manifest itself in a lower rate of house price increase much before the year end. House prices are likely to rise by about 20/25% in the calendar year 1979. If the mortgage rate rises to 13%, first time mortgagors' outgoings could approach the high levels - as a percentage of income - reached in 1974.

10. The first time purchaser earning £5,200 a year (married, no children) is 40p per week better off after the Budget - income tax cuts plus £3.15, VAT etc increase minus £2.75. If the mortgage rate were to rise by 1% to 12.75% net mortgage outgoings would increase by £1.60 per week, leaving him £1.20 per week worse off overall. 1% on the mortgage rate adds 0.2% to the RPI. (The present RPI increase incorporated as a working assumption a mortgage rate increase).

11. Building societies would be able to help some of their 5 million or so mortgagors avoid an increase in periodic mortgage payments if the rate increases by extending the life of mortgages. There may, however, be little or no room for manoeuvre where a mortgagor's current payment is larger or wholly interest, eg where payments have already been extended in response to prior mortgage rate increases, or where a mortgage was taken out recently at 11.75%, or in endowment (interest only) mortgage cases.

12. PRIVATE HOUSEBUILDING. Housebuilders will be harder hit by mortgage rationing than a mortgage rate increase; though a big rate increase could adversely affect demand. The builders will face difficulty in selling houses. Private housebuilding was broadly stabilised at 140,000/150,000 starts and completions each year since the slump of 1974. 1978 was one of the best in recent years: 157,000 starts and 149,000 completions. But despite the recent private enterprise housing inquiry which suggested 160,000 starts this year, the Department doubt if the number will be as high as this. The last January confidential interdepartmental forecast was 140,000. This now looks optimistic.

Department of the Environment
July 1979

CONFIDENTIAL

ALTERNATIVES TO INCREASE IN THE BSA RECOMMENDED MORTGAGE RATE

1. There are two types of measures which might be used: (a) those aiming to restore competitive interest rates so that the societies can continue to attract the necessary funds; and (b) those aiming to replace shortfall of inflow directly.

RESTORATION OF COMPETITIVE INTEREST RATES

(a) Interest Rate Subsidy (Exchequer assistance)

2. An interest rate subsidy would enable societies to vary their share rates, but to avoid an increase in mortgages rates (on the lines of the Conservative Administration's bridging grant of 1973 (see Appendix)). A direct subsidy of 1¾% would enable the societies to offer a share rate of 13.5% gross without raising the mortgage rate. This would cost £240M gross if it ran for 5 months from August to December 1979; and £170M net of the saving on tax relief if the mortgage rate is thereby kept at 11.75% instead of going up to 13.5%. Such a move would be successful if competing rates of interest fall sufficiently by next January - ie by about 2½% - to enable the BSA to reduce its share rate next January equivalent to the present 11.43% gross and bring in sufficient funds to support a reasonable level of lending.

(b) Reduction in composite rate tax liability (Exchequer assistance)

3. The building societies composite rate tax liability, following the Budget tax changes, may fall from 22½% to about 21%. If their liability were reduced to about 16.5% this would enable them to raise their share rate of 13.5% gross, without increasing the mortgage rate for 5 months. Again this would cost about £240M gross; but about £170M net when allowance is made for the saving in mortgage tax relief. This would show up as an increase in the PSBR. There could be operational difficulties in working out such a scheme because societies run on different financial years.

(c) Societies Operating at a loss (with or without Exchequer assistance)

4. Building societies might in effect subsidise the mortgage rate by running at a loss by paying a higher share rate than could be covered by the mortgage interest rate. This would involve running down reserves. Many societies can afford to do this in the short-term without their reserves falling below the minimum required for trustee status (which varies with size of society). If societies on average offered a share rate of 13.5% gross and kept their mortgage rate at 11.75% for 5 months, reserves on average would fall from about 3.5% to 2.5%. But societies would argue that any attempt to run at loss in this way as a matter of policy should not be on such a scale and that such a policy could lead to a damaging loss of public confidence.

5. An Exchequer guarantee useable if a society's reserves fell below a specified level might be offered. But this is most unlikely to be acceptable to the generality of societies, and there are objections of principle to Government virtually underwriting the security of the movement.

MAKING GOOD SHORTFALL OF INFLOW

(d) A short term government loan (Exchequer assistance)

6. The Government could make available short-term block loans which the societies could use while inflow remained inadequate to sustain present liquidity and planned lending levels, as was done by the Labour Administration with loans of £500M in May 1974. (See Appendix). A

comparable operation now could involve short-term loans of around £150M a month for five months (a total loan of £750M). This would bring up net inflow from an estimated £200M to £350M a month. But competing rates would have to drop by 6% by January 1980 for most of the loans to be repaid in the current financial year. So short term government loans would inevitably involve heavy public expenditure in 1979/80 as well as adding to the PSBR and the growth of the money supply in the current financial year. If the loans were made as before at ½% below the mortgage rate (ie 11.25%), the final net cost to Government might be around £15M-£20M, assuming that the Government borrows at about 14%.

(e) Persuading Societies to make greater use of their liquidity (with or without Exchequer assistance)

7. Until a few years ago, societies tended to regard average liquidity of 14% to 16% as their norm for liquidity, rather than 17%, (the statutory minimum for trustee status is 7.5%). These average figures conceal very wide variations between societies. Societies justify this upward shift in liquidity ratios by the greater variability in markets: they accept that on occasion their liquidity will fall significantly below 17% because of unforeseen events but they think it wrong to budget for it to do so. Nevertheless, if societies collectively ran down liquidity from an average 17% (seasonally adjusted) to 15% over the rest of this year it would release £800M for lending.

8. Again a Government guarantee might be offered, convertible into a cash loan from Government if societies got into difficulties as a result of running down liquidity further than they would otherwise have done. But this would involve societies in selling gilts etc, and aggravate the Government's task in funding the PSBR. And it would be very difficult to persuade the societies to agree to run down liquidity on this scale, whether or not backed by Government guarantee.

(f) Persuading societies to make some reduction in liquidity and raising short term loans on wholesale money market and/or Eurodollar market

9. A final possibility might be (i) to persuade those societies with substantial liquidity to maintain lending by running down liquidity faster than they otherwise might - perhaps by a sum equivalent to a reduction in average liquidity of 1% rather than 2% in liquidity (£400M); and (ii) to raise short terms loans of totalling say £500M in the wholesale money market and/or Eurodollar market. This would involve paying a high marginal rate (14% including the price of forward cover in the Eurodollar market), but many societies could absorb such an additional cost over 5 months by smaller additions to their reserves. Insofar as the Eurodollar market is concerned, it would also involve changing the rules governing access to the Eurodollar market by private institutions (eg the Exchange control rules at present prohibit private bodies from borrowing less than 2 years, whereas societies in theory would want 6 month money.) But again the possibility of persuading societies collectively - as opposed to individual societies - to act in this way is not great. Too many societies would probably refuse on grounds of principle, practice and/or prudence for it to be an alternative to a change in the recommended rate structure.

10. Legislation would be required for an interest rate subsidy or adjustment to the composite rate (paragraphs 2 and 3), Exchequer guarantees of reserves and liquidity (paragraphs 5 and 8), or Government short term loans (paragraph 6).

11. The options on interest rate subsidy (paragraph 2) reductions in the composite rate (paragraph 3), Government short term loans (paragraph 6) and running down liquidity (paragraphs 7 and 8) involve increases in public expenditure and/or the PSBR and/or increase in the rate of growth of the money supply.

THE MORTGAGE RATE SUBSIDY OF 1973 AND THE £500M LOAN OF 1974

THE MORTGAGE RATE SUBSIDY, 1973

1. In the first quarter of 1973 competing interest rates caused building society inflow to drop from £158m in January to £60m in March. In response societies raised their share rate to 5.6% on 1 February and to 6.3% on 16 March.

2. But inflow still fell and by 28 March some societies were offering a share rate of 6.75%. On 4 April the Government offered a subsidy of 0.5% for 3 months for mortgagors who would otherwise have paid 10% following the more general rise in the share rate to 6.75%. This was followed by an announcement in the House on 5 April.

3. Agreement was concluded with the BSA, approved by Ministers on 18 April and circulated the next day by the BSA to all societies, members and non-members alike. The agreement set out the basic terms of the scheme: eg which societies were eligible and in respect of which mortgagors. Claims were to be met by a single payment in July, to be followed by audited statements against which the claims would be adjusted.

4. The cost of the scheme, £15m, was met from the Contingency Fund in the first instance. A Supplementary Vote was subsequently provided by the Consolidated Fund Bill on 19 July.

5. During the period of the subsidy competing rates of interest rose, and after the subsidy ended mortgage interest rates rose on 14 August to 10%.

THE £500M LOAN OF 1974

6. Competing rates continued to move against the societies in the second half of 1973. Despite a rise in the building society share rate in October to 7.5% (10.7% gross), by December the differential had widened to -5.4% and remained over -5% until April 1974. Inflow fell to about £80m in Q4 1973 and to about -£10m a month in Q1 1974. Societies reduced their advances to 37,000 a month in Q4 1973 and to 31,000 a month in Q1 1974.

7. On 9 April the BSA accepted a Government offer of a £500m loan facility consisting of:

a. a £100m loan from the Bank of England available from April 1974 at 10.5%. The Bank to provide funds at the minimum lending rate (then 12%) with the difference in cost being met by the Government;

b. an additional £400m as required at 10.5%; the Government raised the loan at rates which varied between 10-12.5%.

8. The principal conditions were that the BSA would not recommend an increase in rates; and the loan would be repaid as soon as possible. Agreement was announced on 10 April by a Statement in the House given by the Secretary of State for the Environment.

9. A Supplementary Estimate was made and then incorporated in the Consolidated Fund Bill to allow the £400m loan to be provided from public funds and the £100m Bank loan to be refinanced from the same source if necessary. In the event the £400m was drawn in 4 monthly tranches of £100m, each subject to the condition that interest rates were not raised.

10. Arrangements for repayment were that the societies would begin to repay from September 1974 on the basis of half of any excess net receipts over £50m a month received by the movement as a whole.

11. During the period of the loan competing rates fell and inflow increased to £115m in August. £381m of the loan was repaid during the financial year 1974/75, the rest in the first half of the financial year 1975/76. Societies increased lending commitments in April 1974 and for the rest of the year they averaged 50,000 a month.

12. The public expenditure costs of the loan scheme was £2/3m (ie the difference between the interest of 10.5% paid by the building societies and the interest paid by the Bank/Government) carried on the DOE vote.

Mr Dow

SECRET

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THE GOVERNOR

GR 3/7

Copies to: Mr. Fforde
The Chief Cashier
Mr. Walker
Mr. Goodhart

MORTGAGE RATES AND HOUSE PRICES

In talking with the Prime Minister, I wonder whether something cannot be made of the political implications of the rise of house prices. In my view, this ought to be a cause of some concern.

The relevance of this point to the Prime Minister might be:

(a) Anything of the nature of a loan to the Building Societies would appear to be feeding the demand for houses and the rise in house prices.

(b) A rise of mortgage rates on the other hand could be presented as a way of moderating demand for mortgage finance.

(It has to be admitted that this argument is not water tight - since a freeze of building society rates would probably do more than anything else to reduce the flow of mortgage finance and thus also the rise in prices. But it could still be a political argument.)

The political arguments might be expanded as follows:

(a) Even 14% mortgage rate is not high, given the present rate of rise in house prices (30% p.a.). and inflation rate of (?) 17½

Post-tax rate 9·1 at 13 / 9·33 at 14

(b) We need to moderate the rise in house prices, and hence need to let market forces work on the mortgage rate.

It is true that a small rise in mortgage rates is unlikely to do much to slow the rise in house prices. Even so higher interest rates are the classic response to rising property prices, and it would be perverse to inhibit this response. First time borrowers would not of course be helped by higher mortgage rates. But they have even more to lose by rapidly rising house prices. If the price of the house they want rises 5% in the two months they spend negotiating, they will have to raise another £1,000 or £2,000 - quite likely to put them out of the market. Higher interest charges on incomes likely to rise by 15% is probably less painful.

JCRD

3rd July 1979.

J.C.R.Dow.

JCRD 13/7