

Elon PSJ
NEDC

PRIME MINISTER

c. Mr. Hoskyns
Mr. Wolfson

Meeting with the Chancellor - Thursday 4 October

The Chancellor will no doubt want to report on the Commonwealth Finance Ministers and IMF/World Bank meetings. Nothing of much significance appears to have happened at either of these meetings. I attach the communique of the Interim Committee. The one significant initiative which the Committee considered was the idea of a Substitution Account: this is the proposal that Central Banks should deposit excess dollar holdings with the IMF and receive in return bonds denominated in SDRs. The Americans and the Germans have been very keen on this proposal because it would take pressure off the dollar. I understand that the Chancellor is rather lukewarm no doubt because he is sceptical about the prospects for SDRs being fully accepted as an international currency. A number of problems remain to be resolved: the size of the Account, the rate of interest that would be paid on the bonds, and the question of exchange risk. The Interim Committee have asked the IMF to do further work on the Account, and report back.

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The world economic assessment which has emerged from speeches in Belgrade is predictably gloomy. Mr McNamara has also, as his wont, been emphasising the plight of the world's poorest - and lambasting the USA in particular for their aid policies.

The Chancellor may also raise with you the question of NEDC membership. Three members - Lord Roll, Mr Michael Shanks, and Sir Leslie Murphy - are coming up for renewal. The Chancellor wants to replace Lord Roll by the Governor of the Bank: this seems very sensible given the intention to build the NEDC up a little (rather than pursue the idea of a separate Economic Forum). Michael Shanks (who represents the consumer interest) has not been an effective member, and the Chancellor wants to replace him - I think with a representative of small business. I think small business should be represented, but so too should consumers - even though Shanks may not be the best person. But if Shanks or someone else represents consumers (Why not a woman? There are none on NEDC at present), there may be a problem in bringing in

a small business representative. One possibility would be for such a representative to replace Leslie Murphy; but I understand the Chancellor wants to keep Murphy on for one more year. The other options are: either to increase the total numbers (but there isn't room round the NEDC table!), or to ask the CBI to give up one of their six places, or to replace Charles Villiers if and when he goes from British Steel (and not to appoint his successor to NEDC).

I have asked the Treasury for advice on when you should take the chair at the NELC. It seems to me that you should do this before long - the general economic discussion which is planned in lieu of the Economic Forum would be a good opportunity. You might press the Chancellor on when this particular meeting is to take place: if it is to have any influence on trade union thinking this winter, it really ought to be no later than December. E decided the meeting should be in December, but the Treasury is showing signs of wanting to put it off.

Other Issues

- i) The Chancellor may want to come back to you on enterprise zones. You have said that he must not announce this proposal at Blackpool - quite rightly since the idea is not fully worked out yet, and Jim Prior is far from happy.
- ii) Exchange Control. I have suggested that the Chancellor should come and discuss his proposal for a further package when he has something in writing - probably the week after next.
- iii) Mortgage Rates. The present position is that the building societies will increase the mortgage rate from $11\frac{3}{4}$ per cent to $12\frac{1}{2}$ per cent from 1 January unless competing interest rates fall back significantly in the meantime. The grossed-up investors rate was put up from $11\frac{3}{4}$ per cent to $12\frac{1}{2}$ per cent in August, and the local authority three-month rate - which is the main competing rate - is currently $14\frac{1}{4}$ per cent. To prevent an increase in the mortgage rate, the local authority rate would need

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to come down to 12 per cent as a maximum - and probably lower. Only in these circumstances would the building societies be prepared to roll back the investors rate to 11 $\frac{3}{4}$ per cent - which is what they would have to do for the mortgage rate to stay where it is and for them to cover their costs. (At present, of course, with the mortgage rate lower than the investors rate they are operating at a loss.) The building societies are beginning to send out notices confirming that the mortgage rate will go up in January. They could send out further notices reversing this if interest rates did come down; but they would need a firm indication of lower interest rates by the end of November if they were to do this - since they need to give a month's notice to investors if there is to be any change in the investors rate.

It seems increasingly unlikely that we will achieve the necessary fall in interest rates in time. Indeed, there could be pressure for a still higher mortgage rate than 12 $\frac{1}{2}$ per cent. For if the present disparity between the three-month rate and the building society investors rate continues, it is unlikely that the building societies will be able to attract enough funds to continue lending at what they and the building industry consider to be a desirable level. The August building society figures show a net inflow of just under £300 million - which is well up on the previous two months' figures, but about £100 million less than what DOE consider to be necessary if their lending is to continue at the present level.

When we considered all this in July, you asked for a contingency plan to be drawn up for either providing building societies with a subsidy, or loans which would be repaid during the current Financial Year. The Chancellor was strongly against any such scheme because of its public expenditure implications, and

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because it would look like a "U-turn" on monetary policy. In addition, the building societies chairman (Leonard Williams) told Mr. Heseltine and Mr. Lawson that they would not be willing to accept a loan or interest rates subsidy scheme. I understand that these schemes are "on the stocks", and could be readily activated; but despite the political difficulties of the 12½ per cent mortgage rate coming through in January, I think the objections to either of these schemes are very great.

Are you content for action on these schemes to be stood down? Or do you want to retain the option of introducing one or other of them? If the latter, I suggest you should mention this to the Chancellor now.

12.

3 October 1979

Subject file
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