CST
FST
Sir D Wass
Sir L Airey
Sir A Rawlinson
Mr Bailey
Mr Littler
Mr Kitcatt
Mr Bridgeman
Mrs Gilmore
Mr Culpin
Mr Ridley

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PRIME MINISTER

MORTGAGE RATE

Since we spoke on Sunday evening, I have checked that there is no question of building society interest rates going up in the next few days. The Building Societies Association Policy Committee and Council meet respectively on 12th and 13th July, and they will be considering the issue then. The Joint Advisory Committee between the Building Societies and departments will be meeting on 5th July, and this will enable us to probe their intentions. There will therefore be time for us to consider this with Michael Heseltine when we return from Tokyo.

2. Present indications suggest that the societies will want to raise their share and mortgage rates. The amount will depend very much on the level of short-term market rates then and on the prospect as they then see it. The present share rate grosses up to 11.43 per cent, which is nearly 2½ per cent below the 3 month rates with which they normally compare their position. If they did not raise their share rate, their inflow would probably be about £200 million a month, compared with the £350 million or so they need to sustain their existing lending levels without running down liquidity. While they would probably not seek to bring their rates fully up to current market levels, since there is still limited scope for running down their liquidity, it is likely that they will choose to move the mortgage rate to at least a full point above the present level of 11¾ per cent, and almost certainly more.

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3. We might be able to persuade the building society leaders to postpone a move until their next meeting in September if we could assert confidently that market rates will have fallen significantly by then. We are not able to do this at present. I would hope that we will be able to have some relaxation of short-term interest rates in the coming months, but cannot be certain of this. We should not reduce MLR until there is clear evidence that bank lending is under control. If we do, we run the risk of having to raise it again later. Also, the scope for a fall in short-term rates is limited. We have set a deliberately tight monetary target; it will not be easy to achieve this with nominal interest rates much below the current rate of inflation (13 per cent). If societies' share rates are too far out of line, they will have to reduce their lending, run down their liquidity (which will prejudice the financing of the PSBR) and be unable to help to finance council house sales. (I know that you would be prepared to see them holding back for the present on this new policy commitment, if that would help hold their rates.)

4. Treasury and DOE officials have already considered possible ways of enabling societies to maintain their lending levels without putting up the mortgage rate. As you know, there are basically two. One is to pay an interest rate subsidy either directly as we did for a few months in 1973 or indirectly by varying the composite rate - this would cost some £25 million per percentage point per month. The other is to advance loans to make good the loss of inflow as the Labour Government did in 1974 - probably £100 or £150 million a month.

5. After re-examining these ideas, I am afraid that I see grave objections to both. They could add an indefinite amount to public expenditure and to the PSBR, since there would be no certainty for how long they would last. They would have an immediate effect on the money supply, at the critical point

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when we need to bring down the rate of growth which we inherited. We have secured considerable credit for our willingness to adopt a tight monetary stance and to take tough measures to secure it. A change of this kind would seriously damage the Government's credibility on that front. In the markets, it would almost certainly lead to other interest rates being forced up against us. Moreover such a change involving public expenditure on this would make it much less easy to resist other claims on the much reduced contingency reserve - if it did not exhaust the reserve itself.

6. I realise that the alternative of allowing building societies to raise their interest rates is unpalatable. That is why it will clearly be important to re-examine the position on our return from Tokyo early next week. But I should not like to leave you with the impression that it will be easy to avoid what must be seen as an inevitable consequence of our general economic strategy in the very difficult circumstances that we have inherited.

7. I am sending copies of this minute to Michael Heseltine and Sir John Hunt.

GH

(G.H.)
25 June, 1979