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Speech given by Nigel Lawson MP, Financial Secretary to the Treasury, to the Annual Conference of the Building Societies Association in the Winter Gardens, Bournemouth, at 2.30 pm on Thursday 8 May 1980.

The British system of housing finance system is unique, and has allowed owner occupation in this country to expand until well over half the families in Britain own their own homes. The figures will be familiar to you: we have seen owner-occupation expand from under 30 per cent in 1950 to 42 per cent in 1960 and 54 per cent in 1978 - the latest year for which figures are available. Over 30 per cent of the total housing stock is owned on mortgage, an overwhelming proportion of which is owner-occupied. In money terms, the total assets of the building society movement have increased from about £1¼ billion in 1950 to over £45 billion at the beginning of 1980. Building society shares and deposits now account for about a half of all of personal sector liquid assets, while bank deposits, by comparison, make up roughly a third.

These figures alone are an impressive testimony to the building societies' achievements in the post-War period. But just as the building societies have grown, so too has your importance to the economy at large, and thus in the formulation and execution of Government policies. You find yourselves inevitably having to face two directions at once. Because of your lending activities you are vital to housing policy; and because of your borrowing activities, you occupy a position of major importance in the financial system, and thus to monetary policy as a whole. I should like to take the second of these points first, and return to housing policy later.

stress monetary policy at the outset because we place overriding emphasis on the need to conquer inflation. Indeed, many of our experiences in recent years have been due to the neglect by previous Governments of this crucial dimension. We have seen the British economy buffeted not just by the storms of outside events such as increases in oil and commodity prices, but also by financial irresponsibility and excessive public expenditure at home. Whereas in the 1960s, the outcome of such developments was periodic balance of payments crises, in the 1970s the full strain was taken on the rate of inflation and the exchange rate.

Our policies for bringing down inflation, and for restoring prosperity to the economy as a whole, represent a decisive change of direction. And like all changes of direction, it will call for some painful readjustment. We have never pretended otherwise. We were forced to increase interest rates in June and again in November last year to bring monetary growth under control. This has caused particular problems for you, and of course for your borrowers, as I and other members of the Government are all too well aware.

Indeed, it is in large measure to prevent the full burden of monetary restraint falling on interest rates in the future that we have put so much emphasis on firm control of Government spending and Government borrowing. The public expenditure cuts already implemented, coupled with those for the period up to 1983-84 announced in this year's Public Expenditure White Paper, offer the prospect of meeting our monetary objectives in the years ahead with significantly lower nominal interest rates. The Medium Term Financial Strategy, published on Budget Day, spelt this out in more detail.

By any standards, ours is a firm monetary policy. But there is nothing unique about it. Other countries faced with similar inflationary problems have adopted similar remedies. In the US, for example, prime borrowing rates have risen substantially this year - despite recent falls. The Federal Reserve Board has also introduced various other restrictive monetary measures. These moves have been prompted by the desire of the US, like the UK, to contain excessive monetary growth and inflation. In Germany and

Japan rises in interest rates have also reflected concern about the inflationary implications of downward pressure on the exchange rate. In the industrialised world as a whole the average rise in nominal interest rates over the past year has been almost exactly in line with the rise in interest rates - of 5½ points at the short end of the market and about 2½ points at the long end - in the UK. The impact of these overseas rises on UK interest rates has, however, been limited. With a floating exchange rate, interest rates are free to respond to the needs of domestic monetary control.

I cannot predict precisely the immediate prospect for interest rates - it depends on developments both at home and, to some extent, abroad. But recent figures for monetary growth are encouraging. The figures for banks' eligible liabilities published yesterday suggest that sterling M3 grew in banking April by a little over ¼ per cent. That means that in the full ten months of our first target period, from June 1979 to April 1980, sterling M3 grew at an annual rate of 10 per cent, which is comfortably within the target range of 7-11 per cent. Moreover within the target period the rate of growth has been falling: over the last six months sterling M3 has grown at an annual rate of around 6½ per cent - slightly below the lower end of the target range. Including acceptances - the so-called bill leak - this still works out at only a little over 7%. If we can maintain this trend - and that will depend to a considerable extent on the course of bank lending - it should clearly be possible to meet our monetary targets this year with somewhat lower interest rates. Certainly, without the reductions in public spending and borrowing that have been announced, the chances of achieving lower interest rates this year would have been very much less. But as it is, the likelihood is that, whereas 1979 was a year of rising interest rates, 1980 will prove to be a year of falling interest rates.

Since monetary policy is so crucial to the conquest of inflation and the recovery of the economy, it is natural that the Government should be concerned about what should - and what should not - be included in the definition of money. We outlined out attitude to this in the Green Paper on Monetary Control that was published on 20 March. At present, we consider that sterling M3 is the most appropriate definition for our monetary target. This comprises notes and comprises notes and coins held by the public, and all sterling bank deposits held by UK residents.

However, as has been frequently pointed out, in many ways, building society shares and deposits are a close substitute for a major part of sterling M3. They can be converted into cash at least as easily as bank deposit accounts, and they are an equally accessible store of wealth - perhaps more accessible because of your convenient opening hours. On the other side of the balance sheet, while building society lending is certainly more specialised than say bank lending it is probably now accepted that there is no hard and fast distinction between the ultimate effects on the economy of building society loans and other types of credit. Although initially a building society loan is tied to the purchase of a house, eventually the money is likely to reach someone who is selling a house and either buying a cheaper one or not buying another house at all. In this way building society loans increase the general purchasing power of the personal sector.

The existence of such a large amount of near-money in the shape of building society shares and deposits means that underlying monetary conditions cannot always be adequately described by the £M3 statistic alone. By sustained control of the money supply over a period, as set out in the Medium Term Financial Strategy, we will squeeze inflation out of the system: but if, for example, everyone switched their savings from banks into building societies overnight this would bring down £M3 dramatically; but it would have little effect on the underlying monetary situation and thus little effect on future inflation.

So we cannot afford to ignore the building societies in our monetary policy. The stock of building society shares and deposits has grown more rapidly than sterling M3 in recent years. Building society shares and deposits were equivalent in size to about one-third of the total sterling M3 stock in 1963, but this proportion has now grown to about three-quarters: building society shares and deposits total over £40 billion, compared with £56 billion or so for sterling M3. Over the last 10 years, the comparative rates of growth are 17% a year for building society shares and deposits and 13% a year for sterling deposits with the UK banking sector. Thus

There can be quite significant divergences in the growth rates of different forms of liquidity and over quite long periods - particularly where major changes of structure or personal preferences are occurring. But the central point I wish to make is this. All the monetary measures will be affected by the same fundamental determinants - fiscal policy and interest rates. When the Government increases or cuts taxes or public expenditure, and when interest rates rise or fall, the building societies feel the effects as well as the banks.

We believe that, on realistic and indeed cautious assumptions, it will be possible to reduce monetary growth over the years ahead consistently with lower interest rates. The basis for this belief is elaborated in our Medium-Term Financial Strategy, which as I said we published at the same time as the Budget. Unlike previous attempts at indicative planning - and I am thinking here particularly about George Brown's ill-starred 1965 National Plan - it is based not on targets for the economy, but on targets for the Government. Not on what we can't control, but on what we can. And it shows that, provided we stick to the expenditure plans we have announced, we have every chance of bringing public borrowing down substantially while still allowing room for the tax cuts needed to boost incentives.

That reduction in public sector borrowing will of itself reduce the pressure on interest rates.

But it will still remain necessary to vary interest rates from time to time to keep monetary growth to the desired path: our Green Paper on Monetary Control discussed possible alternative ways of generating the necessary changes in interest rates - I am sure that you will be contributing to the discussion on that document, and look forward to hearing what you have to say.

As far as the building societies are concerned, as long as you continue to function broadly as you have done over the past decade, it will probably be good enough, for the purpose of monetary policy, simply to maintain the existing techniques of monetary controls as set out in the Green Paper. Within that framework, there will be plenty of room for innovation, as there has been over the past

10 years. I hope you will go on improving your services to members; and you may want to experiment, for example, with slightly more flexible share rates than you have offered in the past.

But if the whole pattern of your behaviour were to change significantly - if, for example, you were to compete more aggressively with the banks for deposits by raising your relative interest rates - then obviously we should have to consider switching the focus of policy more to the wider aggregates which include building society shares and deposits. Whether this would also require changes in the methods of monetary control and their specific application to building societies would depend on the circumstances at the time.

Before leaving the subject of monetary policy, I should like to say a word or two not about the general level of interest rates, but about their volatility. One consequence of the Government's emphasis on monetary policy in the fight against inflation is bound to be that, even when the general level of interest rates falls, we are unlikely to return to the stability of interest rates enjoyed in the early 60s, for instance. As with any commodity, so with money: you cannot control both the amount available and its price. Given our firm commitment to controlling the stock of money, the interest rate is bound to fluctuate in the light of changing monetary conditions. And, under the existing British system of variable mortgage rates, this in turn is bound to cause hardships to your borrowers from time to time. Both the Government and the BSA share an interest in spreading this burden as fairly as possible.

Normally, an increase in the mortgage rate can be met fairly easily by the borrower who is several years into paying off his or her mortgage. His income will probably have risen since he borrowed the money and he will usually have the option of extending the term of his mortgage rather than increasing the monthly repayments. But for very recent borrowers, a small change in the mortgage rate can have a large effect on monthly payments, and such borrowers are normally in a much worse position to cope with an increase. No one would have deliberately designed a system to hit recent borrowers in this way, but that is how it works out in practice.

So if a means could be found of reducing the variability of the mortgage rate for them, at the cost of increasing it slightly for the majority of existing borrowers, who are better able to pay, and for new borrowers, who know what they are taking on, then it would be possible to share out the inevitable burden of fluctuating interest rates more fairly. This is why I am particularly interested in the suggestion your Chairman has made a number of times, that it might be possible to limit the amount by which the interest rate can vary during the first year or two of a mortgage; and in the practice which has been introduced by some societies of only altering borrowers' repayments once a year, to allow some averaging of interest rate movements.

Let me now turn away from monetary policy, and towards the other direction in which you find yourselves facing - namely housing.

Thanks largely to the success of the building society movement, the owner occupied sector has grown over the years, up to now mainly at the expense of the private rented sector. With the virtual disappearance of the private rented sector, the greatest scope for expanding home ownership now is by giving the opportunity to buy to those in the public rented sector. Hence the Housing Bill, now before Parliament, which will encourage the further growth of owner occupation by giving council tenants the right to buy their homes. About a quarter of local authority tenants are already building society investors, and I hope that you will be able to provide finance for many of these sales.

The growth of owner occupation also depends on the construction of new houses, and I realise the difficulties which builders are facing because of the present high interest rates and cuts in public expenditure. In the short run, for reasons I have already explained, these are inevitable. But we are determined to remove all unnecessary constraints on the house building industry so that the framework will be right for a recovery in private house-building as soon as economic circumstances are more favourable. By repealing the Community Land Act, reducing the rate of Development

Land Tax, liberalising the 714 certificate rules and transferring as much as possible of the surplus land owned by local authorities and public corporations to the private sector, we are creating a climate in which house builders will be able to build more easily. And of course you have an important role to play in encouraging builders by ensuring a good chance of mortgage finance to their customers - something you have managed to maintain even when your overall lending has varied.

Increasing the amount of finance available for house purchase is an aim which the Government and the BSA share. If the building societies can enable owner occupation to expand as fast in the eighties as it has done in the seventies, we shall all have cause to be well pleased. But we start the new decade in difficult times. I have already mentioned the present high level of interest rates. Your concern to limit the burden on your existing borrowers has led you to offer savers rates which are relatively less competitive with the banks and with National Savings than your rates have normally been in the past. Your inflows have suffered; and although you have been able to keep up your lending, largely thanks to the large amount of interest being credited to savers' accounts, you have not been able to expand to keep up with the rise in house prices, and are still a long way short of satisfying the demand for mortgages - even at present mortgage rates.

An important contribution to the debate on new sources of finance for house purchase was the interesting report produced by a committee chaired by your distinguished ex-Chairman Mr Ralph Stow, who has given a paper on the subject at this conference. That report concluded that the best way for building societies to meet the likely demand for mortages over the next decade was to concentrate on your traditional source of funds - personal savings - and offer higher interest rates to investors, to enable you to attract enough extra money to satisfy demand.

This suggestion must cause some heart-searching in the building society movement. The conflicting interests of borrowers, investors, and those waiting for a mortgage have all to be considered. The effects on borrowers of permanently higher interest rates - for that is what the Stow Report proposes - and the effects on house prices of an increase in the amount of finance available cannot be ignored. Even if the possible repercussions spread no wider than the housing market, your response to the recommendations of the Stow Committee will require a great deal of thought, because following those recommendations must tend to increase the cost of housing, via both higher house prices and higher mortgage rates. Moreover the effect of such a move would inevitably spread beyond the building society movement and affect the financial system as a whole.

An improvement in the relative interest rates which building societies offer to savers would, at least initially, enable you to increase your share of personal savings. You would have certain advantages over your competitors in doing this, because both the composite rate system and your specialisation allow you to keep margins between borrowing and lending rates small, and because the tax advantages of owner occupation enable your borrowers to accept higher mortgage rates than they otherwise could. Faced with an increasing flow of personal sector funds into building societies, your competitors - the banks for example - might react by raising their own interest rates. The result could be a general level of interest rates which home buyers, helped by the tax relief on mortgage interest, could afford, but which would add to the costs faced by small businesses and industry in general.

These are some of the possible consequences of a move to 'more competitive' interest rates by building societies than the Government must consider: higher house prices, higher mortgage rates, and a risk of higher interest rates elsewhere in the economy. And any move towards behaving more like commercial financial institutions might well call into question some of the special features of the building societies' present treatment.

This may sound as if I am telling you - "if you try to expand, we will make life difficult for you". That is not so. We want to see a further and continuing growth in home ownership, in which building societies obviously have a major part to play. What I am saying is that, if you try to meet demand for mortgages by raising your interest rates nearer to market clearing levels, obviously your position in the financial system will change, and other changes must inevitably follow from that.

Unless that happens, we would not want to impose restrictions on you in the name of monetary policy. Nor do we want to restrict your freedom of action in the name of housing policy - we do not want to reimpose, for example, the system of lending guidelines which was tried between 1975 and 1979 in a vain attempt to regulate the increase in house prices.

The guideline system was based on the idea that, if the Government and the building societies could estimate the amount that building societies could lend in any period, in order to ensure that there were sufficient funds available to finance the purchase of all the houses on the market, at reasonable prices, but no more, then keeping lending at that level would avoid aggravating the inherent instability of the housing market. In practice, however, the complexity of the market has effectively defeated this attempt at fine tuning.

I have no doubt that building society lending is a major determinant of house prices. As I have just suggested, if mortgages were available on demand, for instance, I should be very surprised if house prices did not rise. But, to coin a phrase, there is no mechanistic and succinctly demonstrable relationship between building society lending and house prices. If, for example, prices begin to accelerate, people will be willing to pay a little more than they had planned in order to buy a house quickly. Owner occupiers will get more from selling their houses when they move, and so will be able to pay more for the next one. And if building society lending is limited, people will do all they can to find money from alternative sources, whether from other financial institutions or even from their parents. Less money from building societies can also mean fewer prospective purchasers being successful, rather than the same number of purchasers having less to spend, and the unsuccessful bidders can still keep prices rising. So a limit on building society lending alone cannot prevent a boom once expectations of rapid price rises have taken hold. Nor can we 'fine tune' house prices by adjusting building society lending.

So the message I would like to leave with you today is this: the building society movement has been remarkably successful in providing an invaluable service to home buyers, and as long as your position in the financial system remains broadly as it is now, we want to leave you to get on with it. Of course there will be problems, as there have been in the past, but on the whole the system has proved itself well able to cope with them. We should approach radical changes with caution, and avoid the temptation to look for easy answers.

Of course Government involvement will continue to be necessary in the field of prudential supervision. As measures designed to prevent the repetition of events such as the collapse of the Grays Building Society are introduced, you will probably find your contacts with the Registry of Friendly Societies increasing. In particular, the meetings between the Registry and directors of individual societies which have been taking place will ensure that both sides understand what has to be done to prevent such disasters in future, and protect the interests of your members.

In conclusion I would like to repeat that the Government fully recognises the importance of the building societies to the people of this country - not only to your 5 million borrowers and over 20 million investors, and to all the young couples who hope to become home owners, but also to the financial system on which our economy depends.

We appreciate the efforts you have been making to alleviate, wherever possible, the hardship which your borrowers are experiencing in this difficult time. I want you to know that the Government is grateful to you for all your hard work and dedication; and millions of people all over the country also have good reason to thank you.

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