


CONFIDENTIAL

AMB

Qa 04169

To: MR LANKESTER
From: SIR KENNETH BERRILL

Mortgage Rates

1. The Prime Minister has asked that contingency plans should be made for preventing a rise in mortgage rates. The Department of the Environment is producing a note on possible options. Our own appraisal of the prospects and options is attached, but perhaps I could add some personal comments.

2. The Government's strategy is an ambitious one. Its strength is that it offers the British people a genuinely new approach to our post-war malaise. A new way to achieve the 'turn-round' for which British Governments have been seeking for so long. There are bound to be doubts about whether increasing incentives and reducing the size of the public sector will generate the sort of recovery we need. But what is quite beyond doubt is that a crucial ingredient for success is to establish credibility that there has been a real break with past policies: that cuts in public expenditure will actually happen even if they hurt: that tight monetary policy will not be accompanied by escape clauses when the going gets rough.

3. An increase of 1 per cent in the mortgage rate adds 0.2 per cent to the RPI but only for as long as it lasts. For basic rate tax payers a 13 per cent mortgage rate is, in effect, a rate of 9.2 per cent after tax. With inflation at 17 per cent this Autumn, this is a large negative rate. Moreover, many Building Societies themselves cushion mortgage borrowers by extending the length of the loan rather than raising the monthly mortgage repayments.

CONFIDENTIAL



CONFIDENTIAL

4. Everybody is waiting to see if the Government has the strength of its convictions: not least the Unions who are preparing for the struggles of the next pay round. Action on the mortgage rate could well be seen as the first important test of this Government's resolve to make a new start.

5. I am sending a copy of this minute and attachment to Sir John Hunt.

29 June 1979

Att



CONFIDENTIAL

MORTGAGE RATES

1. It is now widely expected by the media (BBC and United Kingdom Press) that at their meeting on 13 July Building Societies will increase their mortgage and deposit rates. The Societies had a modest negative cash flow last month due in part to the pre-Budget spending spree and in part to the increase in the Minimum Lending Rate (MLR) making the Societies' rates for depositors less competitive. The Building Societies do not meet in August and they will not want to leave their cash flows under threat for the two months ahead. So, although the pre-Budget spending was once and for all, they will want to come away from their 13 July meeting with their rates to depositors reasonably competitive for the months ahead.

The Effect of the Budget

2. The competitive position of Building Societies has not been much affected by the Budget. Before the Budget, with a mortgage rate of $11\frac{3}{4}$ per cent, the Societies were offering a share rate of 8 per cent tax paid (a grossed-up rate of just under 12 per cent). With tax changes in the Budget they could now afford to offer a share rate of about $8\frac{1}{4}$ per cent (11.8 per cent grossed-up). They compete for deposits mainly with local authority three month rates which are currently a little under 14 per cent. Thus the Building Societies are roughly 2 per cent uncompetitive, and this has not been significantly affected by the Budget.

3. It is unlikely that the Societies would seek to redress the full 2 per cent. Left to themselves and in the absence of any fall in market rates the likelihood is that they would raise the mortgage rate by $1-1\frac{1}{2}$ per cent (probably $1\frac{1}{4}$ per cent to a round 13 per cent).



CONFIDENTIAL

Action by the Government

4. The main courses of action which might be open to the Government are as follows:

(i) An interest rate subsidy. This was tried in 1973 in an attempt to hold mortgage rates in single figures. The share rate was subsidised to the tune of $\frac{1}{2}$ per cent for three months. At the end of this period, it was clear that the rate could not be held: the scheme was brought to an end and the mortgage rate rose to 11 per cent.

To be sure of holding mortgage rates at their current level the share rate would have to be subsidised by some $1\frac{1}{2}$ per cent. This would add nearly £40m. a month to public expenditure for as long as the subsidy was required. Since there is no certainty that interest rates will fall substantially in the coming months, the addition to public expenditure could be substantial. The Contingency Reserve for the current year was set in the Budget at £250m. which at £40m. a month would have lasted for six months. But the Contingency Reserve is very small and may well be insufficient to meet needs which can already be foreseen, particularly in the nationalised industries (shipbuilding, coal).

(ii) Government loans to the Building Societies to make good the loss of inflow due to uncompetitive rates. Such a scheme was operated by the Labour Government in 1974. Loans of £500m. were made, most of which were repaid during the course of the financial year following a sharp fall in interest rates.

For a similar scheme to work now, loans of, say, £100-150m. a month would be required. This assumes (perhaps optimistically) that the Building Societies will have a net inflow of about £200m. a month. If in contrast to 1974 there were not a sufficient fall in



CONFIDENTIAL

interest rates to enable the loans to be repaid during the course of the financial year, the effect on public expenditure and the PSBR could be very serious. This type of scheme is also open to the objection that it subsidises the borrowers at the expense of the investors.

(iii) The Building Societies could be pressed to reduce their liquidity below the level they would themselves choose on prudential grounds. There would be difficulties in the Government reconciling this action with their philosophy of non-intervention and financial prudence. But a more important presentational problem is that any reduction in the Societies' liquidity would be at the expense of their holding of gilts - and hence at the expense of an increase in the money supply, at a time when the rate of increase is already pressing against the limits.

(iv) A cut in the Minimum Lending Rate justified publicly on the grounds that the Government was concerned at the effect of increased oil prices on the United Kingdom exchange rate. There will be large OPEC balances to be invested in the West, and North Sea oil and strong sterling will make some look towards the United Kingdom. We do not wish to increase the upward pressure on sterling by the attractive force of high United Kingdom interest rates. Reducing MLR would mean abandoning the monetary targets for the sake of the exchange rate. But unless the market felt that there was a case for an MLR cut - this would depend on, for example, their view of the trade figures and the figures of eligible liabilities - on past experience market rates would not follow the MLR down. And, of course, the Building Societies are competing with the market rates, not MLR.



CONFIDENTIAL

(v) Finally, it might be possible to persuade the Building Societies to hold their rates and keep their cash flow from going negative by reducing their lending. In present circumstances, this would result in a 'mortgage famine' on 1974 lines which, in the light of the Government's wish to encourage owner-occupiers, could not be maintained for long.

CONQUEROR
LONDON

CONFIDENTIAL

UKENIA, LED TO A PARTIAL
CLOSURE OF THE PLANT LAST YEAR.

COMPENSATION CLAIMS - FOR EXPOSURE TO A HAZARD AND REDUCTION
OF LIFE-EXPECTANCY - HAVE BEEN FORWARDED BY SHOP STEWARDS TO
THE LEGAL DEPARTMENTS OF FOUR UNIONS.

THIS FOLLOWS A TOP-LEVEL INQUIRY BY RADIOLOGIST SIR EDWARD
POCHIN, WHOSE REPORT TO THE GOVERNMENT LAST NOVEMBER IDENTIFIED
DEFICIENCIES IN PLANT PROCEDURES, BUILDING DESIGN AND STAFFING
LEVELS.

--

1316

SOCIETY CHIEF WARNS ON MORTGAGE RATES

MORTGAGE RATES COULD RISE TO 12.75 OR 13 PER CENT NEXT WEEK, A
LEADING BUILDING SOCIETY WARNED TODAY.

ALLIANCE BUILDING SOCIETY CHIEF ROY COX SAID THE BALANCE OF
PROBABILITY WAS THAT RATES WOULD HAVE TO GO UP ON FRIDAY JULY
13, WHEN BUILDING SOCIETY LEADERS MEET IN LONDON.

IT SEEMED THAT BUILDING SOCIETY RECEIPTS FOR JUNE MAY HAVE
SLUMPED TO BELOW £100 MILLION, POSING FOR THE BUILDING SOCIETIES
A CLEAR CHOICE OF RAISING RATES OR MAKING THE MORTGAGE SHORTAGE
EVEN MORE ACUTE.

--

1318

MORTGAGE RATES

The average mortgage interest rate under the present Labour Government has been 10.7%. Under the last Conservative Government, the average rate was nearly 2% lower. Only in October 1973 at the height of the world oil crisis did mortgage rates go above single figures under the last Conservative Government.

Thus a householder with a £10,000 mortgage has had his gross mortgage repayments increased by an average of £160 a year under Labour.

Average Mortgage Interest Rate

Conservative Government (June 70 – Feb.74)	8.8%
Labour Government (March 74 – Dec.78)	10.7%

Mortgage Interest Rate Changes

<i>Conservative 1970-74</i>		<i>Labour 1974-78</i>	
July 1969	8½%	June 1976	10½%
January 1972	8%	December 1976	12¼%
November 1972	8½%	June 1977	11¼%
June 1973	9½%	August 1977	10½%
October 1973	10%	October 1977	9½%
November 1973	11%	February 1978	8½%
		July 1978	9¾%
		November 1978	11¾%