## IV. Mortgate Rate

Extract PM's meeting with Gordon Pepper 4.7.79.

The Prime Minister said that it would be disastrous if the mortgage rate rose. If necessary a solution on the lines of the loan scheme devised by Mr. Harold Lever in 1974 should be implemented. But this would only work if interest rates were going to fall before the end of the financial year so that the loans to the Societies would be repaid. Mr. Pepper said that he was certain that interest rates would tumble fast in 1980 because of recession in the USA, the United Kingdom and other major economies. But he was less sure about the next six months. United Kingdom interest rates would fall soon if MLR were reduced. But it would be a mistake to reduce MLR while private sector lending remained high; to do so would be seen as a failure to stick to a policy of monetary discipline. Interest rates ought to fall soon enough to ensure that any loans to the Building Societies would be repaid this financial year; but the timing was still uncertain. Everything depended upon how soon private sector lending came back within reasonable bounds (the latter was currently running at around £800 million per month; it would need to come back to £4-500 million.) The Prime Minister asked if there were other ways of holding back private sector lending other than relying simply on higher interest rates. Mr. Pepper replied that for technical reasons the "corset" was not effective. In fact, the Bank faced a dilemma. Because of the recent heavy sales of gilts, there was pressure on the Bank's liquidity and this was pushing up money market rates. They would, therefore, need to release some special deposits in the near future in order to relieve the squeeze; but if they went too far, the "corset" would become ineffective and private sector lending would not fall. It was very difficult to strike the right balance here: the amount of the special deposit release was crucial. Mr. Pepper went on to say that if and when MLR were dropped, it would be better to reduce it by a substantial amount: to reduce it by small amounts and in stages, would add to the foreign exchange inflow.

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PRIME MINISTER

Housing

MY LUNCH WITH GORDON PEPPER

Gordon Pepper and I went over some of the ground which we covered at the meeting this morning. The following points are particularly relevant to the decision on mortgage rates:

(i) Gordon repeated that he was confident that interest rates would tumble in 1980 because of recession both here and in other major economies. In the shorter term - i.e. the next three months - he believes that interest rates will fall if we reduce MLR. However, he thinks it would be unwise to move MLR before August. This is because of his worries about lending to the private sector which - as he told you - seems likely to be running at a high rate still. A drop in MLR now, and the consequent drop in interest rates would - in his view - put in jeopardy our commitment to controlling the monetary aggregates. (External considerations, of course, none the less, argue for a fall in interest rates. The pound rose to \$2.23 this morning - an effective rate of 71: Gordon, however, would say that sterling must be reduced by a further relaxation of exchange controls rather than an early reduction in MLR.)

(ii) Gordon argued this morning that we should be prepared to lend the building societies sufficient (for example £200 million per month) to see them through their short-term difficulties, but that this should be repaid before the end of the financial year. The object of the pay-back condition would be to ensure that there was no net addition to public expenditure. I questioned him further about the likely market reaction to this - given that in the short run it would mean an increase in the money supply, even though it would be offset later in the

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year. Gordon in fact admitted that commentators such as himself would react adversely, and would comment that the Government was moving away from its firm intentions on monetary discipline. Such comments could obviously have a bad effect on the market, and if so, would put off the fall in interest rates. So, there are clearly considerable risks in going down the ~~lone~~ loan road. These have to be set against the effect on family outgoings if people have to pay higher mortgages.

(iii) Gordon repeated that if the societies are to be assisted, it should be a loan to be repaid a la Harold Lever, and not a subsidy on their interest rates.

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4 July 1979