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c John Hoskyns
Wolfson
Mr James

Copies can be found on
1). Master Set Records
2). Econ Pol. (Domestic Monetary)

10 DOWNING STREET

From the Private Secretary

4 July 1979

Dear Tony,

The Prime Minister held a meeting this afternoon to discuss building society mortgage rates. The Home Secretary, Chancellor of the Exchequer, the Secretary of State for the Environment, the Financial Secretary, the Governor, Sir Douglas Wass and Sir John Hunt were present. The following are the main points which came up in discussion.

The Governor first described the monetary and interest rate background to the reports that mortgage rates are likely to rise. Banking figures for June were not yet available, but it seemed likely that lending to the private sector had continued at a very high level - between £700 and £900 million. The Government's funding programme, particularly over the past few days was going well; but the cointinued high level of private sector lending meant that the money supply was continuing to grow at about 13% at an annual rate - significantly higher than the 7-11% monetary target . The increase in MLR in the budget had been primarily designed to arrest the recent increase in bank lending, but this was unlikely to have a quick impact. It was essential for the time being to maintain MLR at its present level until the reduction in bank lending began to come through. To make any reduction now would suggest that the Government were no longer determined to maintain its policy of monetary discipline, and would make it impossible to achieve the monetary target. On the other hand, there was a good case for a release of special deposits which would help to keep short term rates down: because of the recent gilt sales, the banks were facing a liquidity squeeze and this was forcing up short term rates. With a special deposit release, short term rates would be prevented from rising any further, and this would be helpful to the building societies. He hoped that it would be possible to make an announcement either tomorrow or next Wednesday.

The Prime Minister said that she accepted that, in view of the worries about the money supply, it would not be possible to reduce MLR immediately. However, she was determined to avoid any increase in the mortgage rate. Any increase would mean a further rise in the RPI, which would be seen as Government induced; and this would be politically very damaging. If the mortgage rate rose at all, it was likely to go above 12¼%, which would be

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higher than it had been in 1976. Home owners would not understand why the rate had to be higher than it had been then, when the economic situation was now so much better. The reduction in the composite rate should give the societies some extra liquidity; and if they had to cut back their lending, this would be no bad thing in view of the recent escalation of house prices. Some means had to be found to prevent the societies from increasing their rates.

The Chancellor said that the Government's commitment to monetary policy would be fatally impaired if there was any attempt to hold down interest rates by artifical means. He agreed with the Governor that it would be quite wrong to reduce MLR: if building society rates went up, the Government could argue that this was still part of its inheritance from Labour. However, a increase in their rates was still not inevitable. The release of special deposits would tend to hold short term rates back; the societies could be told that there was the prospect of MLR and interest rates generally falling; they could be told that a short term mortgage famine would not be altogether unacceptable; there was the possibility that they could draw on their substantial liquidity; and the reduction in the composite rate should assist them.

The Prime Minister then reiterated her view that any rise in the mortage rate would be politically disastrous . She disagreed that it would be possible to argue that this was part of the inheritance. The pre-budget spending spree, which appeared to have continued, was all too likely to be attributed to the new administration; and this had clearly influenced the level of private sector borrowing. She was opposed to any subsidisation of the societies' interest rates. But the Government should be prepared, if necessary, to lend them money on the condition that it had to be repaid during this financial year. This would be on the lines of the scheme put together by Mr. Harold Lever in 1974.

The Financial Secretary pointed out that a lending scheme could be very costly in terms of public expenditure if interest rates failed to fall and the societies were unable to repay. The cost might be as high as £750 million. The Secretary of State for the Environment commented that home owners were already subsidised, and that on existing mortgage rates there was already a substantial queue of potential borrowers. The recent spending spree suggested that people had money in their pockets, and that an increase in the mortgage rate would not be as politically damaging as the Prime Minister had implied. He was opposed to a loan scheme for the same reasons as the Financial Secretary; and he would prefer to see the mortage rate rise so as to maintain the current level of lending for the sake of the construction industry.

After further discussion, it was agreed that there was a reasonable prospect of persuading the societies to hold their interest rates at present levels at least until September. But they would need to be pressed hard; and the arguments mentioned by the Chancellor would have to be put to them persuasively. It would be important to get an undertaking from them that they

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would give the Government advance warning before deciding to raise their rates. The Government should have ready, on a contingency basis, a loan scheme which would be implemented if the societies did decide to increase their rates.

Summing up the discussion, the Prime Minister said that there should be no early reduction in MLR, but action should be taken to release special deposits; the amount and timing of the latter should be left to the Governor and the Chancellor to decide. The Secretary of State for the Environment, accompanied by the Financial Secretary, should see representatives of the building societies urgently and should seek to persuade them not to increase their rates. They should in any case obtain from the societies an undertaking that Ministers would be given due warning of an increase. At the same time, a contingency plan should be drawn up to provide loans to the societies in case they insisted on putting up their rates; but a decision to implement this plan would need to be considered in the light of further developments. The societies should not be told that this contingency plan was being prepared.

I am sending copies of this letter to John Chilcot (Home Office), David Edmonds (Department of the Environment), Paula Diggle (Financial Secretary's Office), John Beverly (Governor's Office), Nick Sallnow-Smith (Sir Douglas Wass's Office) and Martin Vile (Cabinet Office).

Yours ever,

Tim Lankester.

Tony Battishill, Esq.,
H.M. Treasury.