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10 DOWNING STREET

From the Private Secretary 15 June, 1983

During their conversation yesterday afternoon the Prime Minister and the Chancellor referred briefly to the proposal - mentioned in a letter to the Prime Minister from Mr. Michael Richardson of Rothschilds - that building societies might delay the need to raise their lending rates if they altered the mix of their raisings by taking more from the wholesale and less from the retail market. I sent you yesterday a copy extract of the relevant passage from Mr. Richardson's letter.

The Prime Minister would be grateful for urgent consideration to be given to this possibility.

M. C. SCHOLAR

J. Kerr, Esq.,
HM Treasury

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EXTRACT FROM A LETTER TO THE PRIME MINISTER

FROM MR. MICHAEL RICHARDSON, DATED 27 MAY

"I dined last night with the Board of the Halifax as their Guest; I am sure you are already aware of the position but there was a great deal of moaning about the lack of Short Term Funds and an early rise in mortgage rates after the election. It just seemed to me politically dangerous on a question of timing. The 'city' solution would be to borrow on the wholesale, rather than retail, market, through C.D.S. and longer Term Secured loans on debentures."

MCS

10 DOWNING STREET

When I chased HMT for a reply to your letter of 15/6 about Mr Michael Richardson of Rothschilds letter to the PM I was told that John Kerr's letter of 20/6 (attached) covered all the points.

Is this so?

Mark
24/6/83

Yes
MCS 24/6

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

cc CST
FST
EST
MST
Mr Middleton
Sir T Burns
Mr Littler
Mr Cassell
Mr Lavelle
Mr Monck
Mr Ridley
Mr Pirie
Mrs Lomax
Mr Peretz
Mr Hall

20 June 1983

Michael Scholar Esq.
10 Downing Street
LONDON
SW1

Dear Michael,

The Chancellor has asked me to send you the following report on developments in the markets, and over the mortgage rate, in the last week.

In the foreign exchange market the pound, which had eased at the end of the previous week on post-election profit-taking, declined on 13 June on expectations of some tightening in US rates, combined with falling UK rates. The dollar strengthened. It was rumoured that the Government were seeking a lower exchange rate and also wished to see domestic interest rates lower, in order to head off a rise in building society rates. These factors led to downward pressure on sterling, and from an opening level of $1.5720, 86.5 effective, the pound fell back to $1.5130 and 83.9 by noon on 15 June. Since then markets have been calmer, and, with the dollar easing on profit-taking, the pound recovered to close on Friday at $1.5250 and 84.0 - not far from the level when the election was announced. Today sterling has opened stronger, at $1.5330 and 84.5.

The Bank reduced its dealing rates in two ¼ per cent steps on 13 and 14 June, bringing the band rate down from 10 1/16 per cent to 9 9/16 per cent. This move was associated with falling inter-bank rates - at the beginning of June three-month inter-bank rate stood at around 10¼ per cent; it was down to 9 7/8 per cent by 13 June and remained at, or slightly below, that level for the rest of the week. Following these developments the clearers announced on Tuesday a ½ per cent reduction in their base rates, to 9½ per cent. With the exception of the period in November last year when base rates briefly stood at 9 per cent, they are now at their lowest level for five years.

Gilts showed sharp gains on 13 June. This was in contrast to the behaviour of the exchange market and may be explained by the different consequences of falling interest rates for gilt prices. But on 14 and 15 June the nervousness in the foreign exchange markets spread to the gilts market. Only £2 million was subscribed on 16 June for the new £800 million tranche of 9½ per cent 1988 stock. But this was the first day of banking July and, after gross sales of almost £1600 million in banking June, urgent sales of the new stock were not necessary. The Bank's need was rather to replenish its supplies of marketable stock to tap out at appropriate moments in the new banking month.

The hope now is that we shall continue to see the consolidation of the less nervous tone seen at the end of last week.

Turning to the issue of the mortgage rate, the Prime Minister knows that a meeting was arranged on 16 June between the Economic Secretary and a delegation of Building Society representatives led by Mr Roy Cox, Deputy Chairman of the Building Societies Association and Chief General Manager of the Alliance.

The Economic Secretary, though stressing that decisions on the level of their interest rates would continue to be a matter for the building societies, suggested that it might be against the societies' own interests to reach a decision at their meeting on 22 June. To raise rates so soon after the election might be taken as confirming suggestions by the Opposition during the campaign that a rise had been deferred for political reasons until after 9 June. Delaying a decision till the BSA regular monthly meeting on 8 July would mean that an increase would come into effect on 1 August rather than 1 July, and could be explained by the need to see how the post-election markets settled down in response to the ¾ per cent cut in the 7 day deposit rates offered by the clearing banks and the obscure outlook for US interest rates which could be affected by the decision on Mr Volcker's reappointment.

Mr Cox agreed to pass on these points to the BSA Chairman, Mr Walden, and other members of his advisory Committee, which will meet on 21 June, to discuss the handling of the full Council meeting on 22 June. But he maintained that, even if some of BSA leaders were to accept the case for delay, it would be very unlikely that they could restrain the full Council from yielding to the accumulating pressures for a decision this week; an increase was generally expected after the BSA's announcement on 10 June of the special meeting on 22 June. A decision would have been taken on 10 June had it not been the day after the Election. Mortgage demand had been very strong, and inflows inadequate, since the turn of the year. The building societies had fixed their interest rate structure in November when bank base rates were 9 per cent and seemed likely to fall further. In the event of course interest rates generally had subsequently risen, and even now were not back at the November levels. The cut-back in the banks' mortgage lending had added to the problem. Societies' liquidity had fallen sharply and would continue to do so unless either inflows were raised by about £300 million a month, or societies' mortgage lending was cut back more widely and sharply than had so far been done, although queues had already lengthened. (The attached table illustrates these points.) Some of the larger societies which were capable of raising money at fine rates in the wholesale money markets were doing so on an increasing scale (see annexed note), but the scope for this was limited. Against this background of a cumulative run-down of liquidity, of a prior postponement, and of the announcement on 10 June, Mr Cox's personal feeling was that a decision on 22 June that rates must go up would not be widely seen as political.

The Economic Secretary was left with the impression that although the meeting had been well worthwhile, it was on balance unlikely that a decision would be delayed beyond 22 June.

In the light of the interest rate reduction last week, it seems likely that the increase in the mortgage rate will be 1 per cent. This will raise the July RPI, to be published in August, by about 0.3 per cent. If a corresponding reduction in mortgage rates were made by 1 October, there would of course be no net effect on the RPI published in November.

I hope to be able to let you know late on 21 June the outcome of the advisory Committee meeting, and hence the likely decision on 22 June.

Yours ever,

John Kerr.

J O KERR
Principal Private Secretary

seasonally adjusted

	Liquidity ratio (end period)	Net receipts	Net increase in shares and deposits, including interest credited	Net advances (net of repayments)	Gross advances	Net new commitments
	£m	£m	£m	£m	£m	£m
1982 Q1	19.1	1224 (967)*	2311	1275	2754	3323
Q2	19.5	1489 (1344)	2499	1922	3768	4031
Q3	20.0	1608 (1796)	2623	1984	3897	4077
Q4	20.0 (20.6)	1925 (2139)	2842	2674 (2618)	4717 (4780)	5273 (502[illegible])
1983 Q1	18.0 (17.7)	1550 (1174)	2390	2933 (2821)	5196 (4789)	5284 (50[illegible]0)
October	20.2 (20.6)	728 (886)	1049	838 (830)	1490 (1469)	1591 (16[illegible]4)
November	20.2 (20.7)	822 (763)	1148	882 (945)	1552 (1659)	1760 (17[illegible]9)
December	20.1 (20.6)	375 (490)	645	954 (843)	1675 (1652)	1922 (1590)
January	19.4 (19.2)	450 (391)	725	955 (867)	1728 (1427)	1706 (1479)
February	18.7 (18.3)	515 (386)	795	918 (849)	1637 (1450)	1772 (1[illegible]16)
March	18.0 (17.7)	585 (397)	870	1060 (1105)	1831 (1912)	1806 (1905)
April	17.8 (17.6)	431 (433)	719	900 (901)	1620 (1593)	1572 (1[illegible]91)
May	17.2 (17.3)	(319)**		(981)	(1664)	(1[illegible]02)

* bracketed figures not seasonally adjusted

** excluding wholesale money of about £75 million, roughly £50 million more than the flow in March and April

ANNEX

BUILDING SOCIETIES AND WHOLESALE MONEY

The Finance Act enabled building societies for the first time to issue certificates of deposit (CDs) in addition to their other wholesale borrowing by allowing them to pay interest gross ie without deducting tax (as banks already can). This opportunity has been used quickly. Since the first issue roughly a month ago, some of the largest societies have, between them, probably issued around £100 million of CDs, nearly all with one or three month maturities. Because the issuers are of the highest calibre (Halifax, Abbey National, Nationwide, Alliance) and because there has been no attempt to flood the market, the rates obtained for these issues have been very good, with societies paying only 1/16 % more than top bank names for 1 month issues and ⅛% more for 3 months. These results are very good given that:

a. monetary sector institutions get a roughly 1/16 % pa better yield from holding bank rather thansocieties' CDs (because they can offset the former but not the latter in calculating their Eligible Liabilities*); and

b. some participants in the money markets (eg the clearers) will - at the least - take time to accept societies CDs on a par with bank CDs in their portfolios or as security for loans.

2. If, however, second-line societies came into the market (and to judge from the bank CD market only very good names trade at all easily) or if the large societies pushed too aggressively, relative rates could move away from all societies quite quickly. On the experience of the bank CD market, most smaller societies would be unacceptable at any reasonable price even if the Registrar allowed them to issue.

3. Once an adverse differential of ¼% or even more was established it would be very hard later for societies to claw that back. Short-term maximisation of the inflow to CDs would therefore be likely to impose a permanent relative cost and, in any case, just as there are only about 10 banks whose CDs trade actively at fine rates, it is realistic only to think of the largest 10 or 12 societies tappping the market. Without

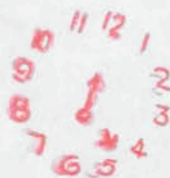
* on which their compulsory non-interest-bearing balances with the Bank of England are based.

due pressure on the market, it would not however be unreasonable for the large societies in aggregate to hope to raise an additional £100 million a month in CDs for the next month or two.

4. It is too early to judge what might happen thereafter. But it is clear that the long-term development of this market, as a permanent source of finance, would be threatened by seeking to expand it even faster than it has done already.

5. Although a further increase in the societies' use of wholesale money will be valuable, it also has some disadvantages. First its cost is relatively high. Until this week yields on building society CDs were at or above the published mortgage rate of 10%. Societies will have been making a loss at the margin. Yields have now come down to about 9⅞%, but this is still well above the average cost of funds from persons, which is under 9¼%. Secondly the cost of wholesale money is likely to fluctuate. If it became a large contribution to societies' funds, it would add to the other factors tending to make building society rates change more frequently. Finally it is bound to be uncertain whether CDs can be rolled over when they mature. Although not all societies would accept this, their prudential supervisors think that this raises the ratio of assets the societies need to keep liquid so that they can lend long while borrowing short without putting their depositors at risk.

24 JUN 198[illegible]



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With the Compliments

of the

Chancellor of the Exchequer's

Private Secretary

Treasury Chambers,
Parliament Street,
S.W.1.

10 DOWNING STREET

THE PRIME MINISTER

15 June, 1983

Dear Richard

Very many thanks for your letter of 27 May. I am sorry not to have replied to it sooner but as Caroline explained to you she has not been in the office for the last month and so your letter was not opened.

I am extremely grateful to Rothschilds for their generous donation and I know we have you to thank for it.

With all best wishes,

Yours ever

Margaret

M. Richardson, Esq.

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Direct Line 01-280
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May 27th.

Dear Margaret.

Remembering the conversation we had in the hallway at Chequers, I just thought you would like to know that Rothschilds have made, for the first time, a contribution to the Party. We are all 100% behind you in the brilliant campaign you are waging; the conversion is complete, largely thanks to Victor!

I dined last night with the board of the Halifax as their guest; I am sure you are already aware of the position but there was a great deal of moaning about the lack of short term funds and an early rise

in mortgage rates after the election. It just seemed to me to be politically dangerous as a question of timing. The 'city' solution would be to borrow on the wholesale, rather than retail, market, through C.D.s and longer term secured loans or debentures.

Thank you so much for all you are doing to make this country great again.

Yours ever

Michael.

P.S. No answer needed but looking forward to seeing you for lunch on July 4th.

M.