CONFIDENTIAL

PRIME MINISTER

We are meeting tomorrow to discuss building society mortgage rates. The next meeting of the Joint Advisory Committee is on 5 July; the Council of the BSA meet on 13 July. The present BSA savings rate is 11.43% - about 2.5% below competing rates. On this basis, net inflow might run at £200m a month. The societies need around £350m/400m a month to keep up the present level of mortgages - about 60,000 a month, a figure which societies and builders believe is too low. Before the MLR increase societies were attracting around £300m a month.

I have spoken today to Leonard Williams, the Chairman of the BSA. His view is that it is very likely that the societies will need to raise the mortgage rate from its present level of 11.75% to competitive levels, to prevent lending from falling too far below 60,000 commitments a month. He also took the view that whilst there was some scope to reduce liquidity this would happen in any event and would be more acceptable if the societies believed that the present level of MLR was short-term.

In my view the best short-term solution would be to persuade the major societies to keep up lending by some running down of liquidity - a 1% reduction would yield about £400m - and to maintain the interest rate structure at the present level. Our case would be stronger if we could provide some signal of our determination to bring down the general level of interest rates before the Council meeting on 13 July. This could take the form of a reduction in MLR. This course would only make sense if we believe that there is a real prospect of a substantial fall in competing rates by early autumn since this would remove pressure on the BSA to increase their rates later in the year. We should need in any event to put strong pressure on the BSA leadership. I am advised that without some form of signal before 13 July the majority of the BSA Council may well feel obliged to recommend an increase in their rate structure.

All the other options are unpalatable. We could decide not to seek to influence the BSA. This could lead to rates of around 13.5%. This has the advantage of maintaining our stance of non-intervention and it should bring further pressure to abate the continuing rise in house prices - still running at around 30% although there are some signs of tapering off. However, this would mean a new record level mortgage rate, with the political consequences of which we are all aware. An increase in the mortgage rate to 13.5% would leave the new first-time buyer on £5,200 a year with an average mortgage worse off despite the Budget.

I discussed other forms of direct intervention with Mr Williams. One option to consider is subsidising the mortgage rate, perhaps for the rest of this year, either through direct Exchequer subsidies as in 1973 or through a reduction in the composite tax rate liability or through a combination of the two. A direct subsidy of 1.75% would enable the societies to offer a savings rate of 13.5% without raising the mortgage rate. This would cost £240m gross (£170m net of saving on tax relief). This assumes that competing rates fall by 2½% by the end of 1979. A reduction in the composite rate to achieve the same savings interest rate would cost about the same. Legislation would be required. Mr Williams said that in his judgement his members would be antipathetic to this.

He was less hostile to the possibility of the other main option: short-term Government loans which the societies would repay when inflow picks up again. This was done in May 1974. We might need to find around £750m by the end of the year - and it is not likely that the societies could repay during this financial year as competing rates are unlikely to fall far enough: the net amount would thus add to the PSBR. Legislation would be required.

I have looked at various other options, including the societies operating at a loss, perhaps with Exchequer guarantees ; or even greater use of liquidity with guarantees. But the movement will see strong commercial objections to a conscious sharp reduction in liquidity or reserves; and there are objections of principle to Government in effect underwriting the movement by backing such reductions with Exchequer guarantees. Mr Williams made the point that devices of this sort led to repeated media comment about Government propping up the movement - a criticism he also made of government short-term loans. An interesting option is use by the societies of the wholesale and/or Eurodollar market for short-term loans. But although I want to see this proposition fully explored as part of the review of house purchase finance, and am ready at any time to discuss it with the BSA leaders, I do not think it possible in the time available to persuade enough societies to develop such an operation, on a scale sufficient to make good the current shortfall in inflow from their traditional sources.

My own conclusion is that in the last resort if we are faced with the choice of higher interest rates or Government assistance we should not intervene. If we do intervene, we should have to find very considerable sums of public expenditure immediately after a period in which we have striven to make real cuts. It could also be a signal for others to argue that short-term measures should be followed on the grounds of political advantage irrespective of the Government's longer-term resolve. We are, of course, to discuss tomorrow: in the light of that discussion I will personally be prepared to see the BSA leadership after the official discussion at the JAC on Thursday.

SECRETARY OF STATE FOR THE ENVIRONMENT

I am copying this to the Chancellor of the Exchequer, the Home Secretary, Sir John Hunt and the Governor of the Bank of England, all of whom I understand will be present.

MH

3 July 1979