

# A guide to the way the Bank controls the bond market and interest rates

I have often been asked recently to explain how bonds work and why the market fell this autumn.

The government needs to borrow money for spending in excess of tax revenues. The Treasury (Debt Management Office) issues bonds or gilts. It borrows money from investors, offering them interest and a repayment date for the loan. People and investment funds buy the amount of these big issues they want. The normal bond called a gilt offers a fixed rate of interest with regular cash payments of interest to the holders. The bond has a repayment date so you can choose to invest for a shorter time period or for many years.

If you change your mind and want to get your money back before the bond repays you can sell it to someone else in the market. If interest rates are unchanged since you bought it you can sell it for what you paid for it. If interest rates have gone up you will sell it at a loss. If you bought a 1% 1 year bond for £100 when 1 year interest rates were 1% you would sell it for £99 if rates went to 2% immediately. The buyer would want the £1 capital gain on repayment of the £100 as well as the £1 of interest he would receive by buying it at £99. If you had bought a bond that repays in 50 years time or longer you would experience a much bigger loss as the buyer would need a large capital gain to offset 50 years of too little interest. Roughly you would lose half your investment.

The Bank of England exerts huge control over this market. The Bank owns around one third of all the bonds government has issued following its huge bond buying programmes. It fixes the interest rate for short term borrowing and strongly influences interest rates for longer term borrowing. All the time from March 2020 to end 2021 that it was a big buyer of bonds it drove prices of short and long bonds up. This meant ever lower interest rates available to any investor wanting to buy a bond. Many sold out to the Bank seeing the prices were crazily too high.

In the run up to the Truss growth package both the US Fed and the Bank of England were talking their bond markets down. Both wanted interest rates higher and were threatening further large rises in the rates they set. They got the markets falling. The ten year UK bond rate started to rise from offering an income of 3.1% on September 19th following the Fed. The Bank of England the day before the Growth Statement on 22 September went further and announced it planned to get rid of £80 bn of bonds over the next year, which was bound to drive prices down further. This created turbulence which forced some pension funds to have to sell bonds in a hurry to find the cash to cover their losses on so called LDI funds. These funds own more bonds than they can afford to pay for by using futures. Fast falls in price require them to make payments to cover losses.

It is true the absence of reduced spending plans and of borrowing figures in

the Growth Plan led to a further decline in prices after the announcement on 23<sup>rd</sup>, but this followed a week of falls in response to the Bank wanting bonds down. More falls followed mainly owing to the LDI panic. The ten year interest rate hit 4.5%. The Bank showed it controlled the market by sharply reversing the falls with an intervention on 28<sup>th</sup> announcing suspension of bond sales. The ten year rate is now where it was on September 19<sup>th</sup> before the Bank said wanted rates higher, back at 3.1%.

The two biggest influences causing the falls in bonds up to 28<sup>th</sup> September were the Bank of England deliberately driving the price of bonds down to raise interest rates, and the LDI/pension funds having to sell bonds as they scrambled to deal with their overcommitted positions. The markets rallied only when the Bank said it wanted rates lower and bond prices up proving its power.