[A guide to what has gone wrong in the bond market.]

The UK government needs to borrow a lot of money to cover what it spends in excess of what it gets from taxes. It pays different interest rates on its borrowing depending on how long it wants to borrow for. Money borrowed for a few months is borrowed at around the Bank rate the Bank of England fixes and publishes, currently 4.5%. To borrow for say ten years the government sells ten year bonds to people, pension funds and insurance companies that hold our savings. These bonds take the money off us for the government to spend. The government promises to repay it in ten years time, offering the lender/saver an guaranteed annual rate of interest. This is currently at 4.3%.

The Bank of England has huge influence over how much the government has to pay in interest. By setting a higher Bank rate it usually drags the longer rates upwards. It can say it wants rates to go higher and that will often send them up. It owns a large quantity of the government bonds which it bought up at very high prices in recent years. It can sell some of these to drive the price of the government bond down which pushes up the interest rate.

By way of simple example if the Bank owned a 1% government bond with no repayment date the bond would trade at £100 per £100 issued paying £1 in interest every year to holders all the time the Bank wanted long rates at 1%. If the Bank wanted to put long rates up to 2% the value of all those bonds would halve to £50 per £100 saved, so the £1 of interest gave the new buyer 2% on the £50 they spent to buy it from the original holder. The losses are lower the shorter the time to repayment of the bond. A 1% 1 year £100 bond would fall by £1 in value to £99 if rates doubled to 2%, so the new buyer would earn the £1 of interest over the year and would be paid back £100 for the £99 he had paid for the bond, giving £1 of gain making £2 in total return.

In 2021 when the Bank of England was wanting to boost inflation and the economy it bought up huge quantities of bonds to keep all rates very low. It allowed the government to borrow ten year money for just 0.2%. Now today it panics about the inflation it has helped create. Last autumn it decided to drive bonds down greatly by announcing a huge sales programme of £80bn a year of sales of bonds just before the mini budget and said it wanted bonds down and rates up. Rate soared to over 4% from the lows of the previous year. The sell off was exaggerated by some geared pension funds having to sell to raise money to pay for bonds they had bought without the money to pay for them in full. In recent days prior to the publication of disappointing inflation figures the Bank again said it wanted rates up and was thinking of selling or cancelling more bonds next year following a review. Bonds were falling as a result before the inflation figures which added to the woes of the market. Bonds are back to similar levels to last autumn. There was no extra selling pressure from overcommitted pension funds this time round.

This should worry the Treasury and Bank. This will make it more difficult to pay for government spending going forward and makes a recession more likely. A recession will increase the deficit, the amount government needs to borrow by depressing tax revenues and hiking spending on the unemployed.

Selling the bonds at large losses is what they call Quantitative tightening. The Bank told Parliament it would have little impact on inflation and they were doing it just to reduce the size of their balance sheet as a technical exercise. I think they are wrong about all of that. I think big sales at losses destabilise markets and raise interest rates more than needed. If they are right and these sales are unimportant to their policy why not suspend them to ease market nerves? Holding the bonds until they mature will still bring down the size of the balance sheet in due course and it will spare taxpayers some of the large losses currently running at £12bn a year.