

Government bonds and mortgages

I have been in demand by MPs and the media to explain how the bond markets work. As daily we have front page news of movements in the price of bonds and therefore in the longer term rate of interest, let me have another go.

If a government issues some debt to pay some of its bills, it promises to make a regular fixed payment of interest on the debt. So, let us say it sells £10,000 of debt at 1% interest to a bond buyer, as part of a much bigger issue. For ease of calculation let's say it never promises to repay – there is some debt like that. Such irredeemable debts are similar in the way they behave to long dated debt, 50-70 year debt which is repaid at the end of the stated time. The UK has been issuing some 50-70 year paper which is a debt that only repays a long time hence.

If the Central Bank then decides to put interest rates up to 2% the owner of the 1% paper is being short changed but their interest receipts stay the same. If they want to sell their bit of the debt on as they can do in the bond market, they will find that the price of it has halved. The buyer of the £10,000 bond will only pay £5000, as he wants a 2% rate and the £100 guaranteed interest payment stays the same, to give him 2% (£100 divided by £5000).

We have just lived through a period when the Bank of England has bought up £875bn worth of bonds, at ever crazier prices, taking the interest rate on them down to tiny amounts. Now they wish to drive interest rates up. They can do so by having the sole power to set the official short term rate of Bank rate which we know, currently now up to 2.25%. They can also do so by manipulating the price of bonds.

As the largest buyer of government bonds in recent years their decision at the end of last year to stop buying them pushed the market down substantially and therefore longer term rates of interest up. On the Thursday before the Kwarteng Statement the Bank announced it would go further, seeking to reduce its holdings of government bonds by a chunky £80bn. The thought of the Bank selling bonds led to price falls as the Bank must have wanted. To get the longer term interest rates up they need to get the price of bonds down.

By the following Wednesday the bond market had fallen a lot. The decline was bigger in the UK than in other countries where Central Banks were also forcing rates up, mainly because in the UK a lot of pension funds had bought into funds that let them indirectly own more bonds than they had to fully pay for. As bonds fell they had to put up more money for these geared positions, forcing yet more sales to raise money for the calls. The ECB is not threatening to sell some of its huge holdings of bonds as it is worried what that might do to their bond markets.

The Bank then decided this had gone too far and flipped from being a seller to being a buyer again of bonds to try to stabilise the prices. The Bank's own pension fund has exposures to these vehicles. On Friday they changed

again, ending buying with the possible threat of sales hanging over the market. It meant the market fell sharply after the announcement of a change of policy and Chancellor.

It is true some in the markets disliked the absence of forecasts and costings with the Chancellor's measures, but as the gyrations in the week following show the main driver of bonds falling and then recovering was Bank of England action. The Bank can have a big influence on whether mortgage rates go up or go down. The commentary which sees the whole thing as a response to the mini budget is simply wrong. I have always wanted the government to set out costings and present spending and tax at the same time as is traditional.