Bond yields and mortgage rates

In July 2022 the UK ten year interest rate was 2%. In early September it was 3% and by the time of the Kwarteng budget on 23rd September it was approaching 4%. It peaked on 9th October at 4.38%. In July 2023 it made another new peak at 4.65% and stayed high until November. It is now just over 4%.

This pattern was similar to the pattern in the USA and the Euro area. The main cause of large rate rises in all three places was the decision of their Central banks to go in for rapid and severe monetary tightening, as they belatedly woke up to the high inflation they had allowed or caused, depending on your view.

It is true that in the period September 26th to September 28th the UK had a bad sell off in gilts . This was mainly caused by the Liability Driven Investment crisis. The Bank has written of "severe dysfunction in the UK government bond market when distressed forced selling of gilts by liability driven investment funds led to a fire sale dynamic". The IMF also wrote how "liability driven investment funds were at the centre of the severe stress that emerged in the UK gilt (bond) market"

There are those for political reasons who claim all this was brought on by so called unfunded tax cuts in the mini budget. They overlook the fact that the increases in spending were considerably higher than the tax cuts, forget that the gilt market had fallen a long way that month before the budget because the Bank wanted a big rise in interest rates, and forget the role of LDI investors the following week in driving the market down more. The Chancellor did push the deficit up more than I suggested and could have done more to control spending. Nonetheless the pattern of rate rises and falls show that the main cause of the rate increases was Bank policy, and the main cause of the three day meltdown was LDI troubles as owners of bonds they could not afford had to sell to pay their bills. It was very difficult finding buyers when they knew the Bank was about to sell £80 bn worth and LDI investors had to sell lots of bonds as well.

Further proof of this is how the Bank turned the gilt market round. By announcing purchases of bonds and suspending the planned sales the Bank brought the ten year rate back down to 3.1% by 20th November. The fact that the following year after a series of tax rises the rate went considerably higher than in September 2022 again underlines tax cuts were not the main issue.

The Bank of England losses stop a growth policy

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The scale of Bank losses

In the budget figures we were told the Bank of England's bond buying and selling will end up losing us £102 bn. In its early phases the Bank sent the Treasury profits of £124 bn, so on these OBR estimates there are astonishing total losses coming of £226 bn. As of March 2024 the Treasury had had to pay the Bank £49 bn to cover losses to date, so another £179 bn could become due if the OBR has got a forecast right.

These losses are huge and unacceptable. A substantial portion of the loss is avoidable. The government needs to have urgent discussions with the Bank to slash these costs. Other major Central Banks including the US are not receiving any bail outs from Treasury whilst China and Switzerland did not buy too many bonds in the first place. The ECB which made similar mistakes with bonds to the UK is now containing the losses much better with a different approach.

There are two simple changes needed.

1 Stop selling bonds in the market at low prices. The bonds repay on maturity when the Bank will get more for them than current prices, so stop selling.

2. **Copy the ECB approach to payments of interest to commercial banks on their deposits at the Central Bank . The Bank of England is losing too much on the costs of remunerating the reserves placed with it by the commercial banks compared to the interest it gets on the bonds. As the rate paid to banks is a managed rate fixed by the Central Bank cut the losses.**

These changes would lead to a good improvement in the public sector deficit x Bank of England, the measurement they use to control the economy, and to lower mortgage rates.

Bernanke needs to be radical in his

[review of the Bank of England]

Ben Bernanke knows a lot about Central banks getting things wrong. On his watch at the Fed he saw inflation hit 5.6% in 2008 before watching it collapse along with important parts of the banking system. He was there for the banking crash and great recession of 2008-10. He pioneered the money printing and bond buying policy that lies behind the wild ride the UK has experienced in inflation and growth 2019-24.

Recommending the same people on the MPC be asked to publish their own differing forecasts will not solve the problem, as there is too much groupthink on the MPC. Telling them to publish a range of scenarios does not help much either, because what we need and want to guide money policy is a reliable base forecast. How else can they set a good interest rate if they have no idea what inflation is going to be. That is why I have set out the need to completely change their forecasting models, to take money and credit seriously, and to recruit different people to provide diversity of thought.

1.The Bank should immediately conduct an internal review into its models and forecasting to find out why it got inflation so wrong and to propose amendments that would have produced better outcomes. It should back test changes to the model to make sure they would result in material improvements.

2.The Bank should produce an analysis of the role of money and credit in inflation and discuss how this can be monitored and used in helping make policy decisions about rates and money creation going forward.

3.The Bank should ensure in its future recruitment to senior roles on the staff and to external appointments on its committee that it appoints to obtain a greater diversity of views about economics and inflation. It should wish to have representatives of the main strands of economic thought on the important topics around the table.

4.The Bank should reward staff when it hits targets for accuracy of forecasts and success of out turns to policy decisions.

5.The Bank should reconsider its attitude to Quantitative quantitative tightening. If it is unimportant as an influence on inflation as it says and the
purpose is technical or tidying up it should stop selling bonds and let maturities gradually reduce its balance sheet. It should consider whether its bond sales do depress markets in ways which can disrupt them, consider the flow across to its tasks in maintaining banking sector stability and ask whether too many bond sales might make a recession more likely. Selling bonds at huge losses and sending the bills to the taxpayer is encouraging recession and preventing a growth policy.

Reduce government interference in energy

One subsidy leads to another. One windfall tax soon becomes several permanent tax rises on overtaxed energy. One price distortion tempts Regulators to do more. Instead of pursuing the three aims of security of supply, affordable power, and environmental requirements we end up with energy which is too dear and a growing dependency on imports and the goodwill of foreigners.

The boost to oil and gas prices caused by the decision to get Russian oil and gas out of our supply chains in retaliation for the invasion of Ukraine was used as an opportunity to increase taxes on oil and gas. It was called a windfall tax though the government did not specify what element of the price/profit was windfall, nor did it promise to cancel the tax when oil prices fell back. This then caused super profits for older renewable electricity investments so they too were put under a windfall tax. Subsequently new investment in renewables was exempted . All this reinforced dearer energy, so then the government decided to spend a fortune on subsidies to domestic consumers. The government introduced a price cap on domestic energy bills. As prices fell so the price cap held costs up until the next review point. All these interventions were backed by the Opposition parties who usually wanted them to go further, last longer and tax and subsidise more.

This is a wasteful and worrying model for energy. It has meant higher public sector spending and borrowing. It has deterred investment in new capacity through the higher and unpredictable taxes. It has helped close factories in the UK thanks to high energy prices, increase energy imports, and increase the imports of energy intensive goods.

The same thing is happening with energy using products. It is wrong to tax car producers for selling too many petrol vehicles that people want to buy, and for selling too few battery cars which people do not want to buy. It would be wrong to tax gas boiler manufacturers or to ban their product if people do not want to buy heat pumps. Government did not need to step in to ban blackberries in order to promote smart phones, or to boost computer pads by taxing home desktops. There was no subsidy to promote mobile phones or internet services. Good products sell because people want them.

Get a grip on nationalised industry costs

When we had many nationalised industries they dominated public accounts and caused some of the overspending and over borrowing that damaged the Labour government of 1974-9. Nationalised industries sacked a lot of employees, over charged customers and often lost taxpayers huge sums. Rail, coal, steel were in painful decline. Telecoms fell well behind technically with shortages of investment.

Today the public accounts are being damaged again by two nationalised industries, rail and the Post Office, and by the colossal losses of the Bank of England. Since 2022 the Bank has demanded £50 bn from taxpayers to pay its bills. Network Rail has just got approval for £30 bn of taxpayer cash for the next five years. The Post Office has lost £1400 m in recent years and now expects taxpayers to pay up for all the repayments and compensation they owe the sub postmasters.

I have often reported on the needless damage to the accounts being perpetrated by the Bank. The Fed does not send its losses to the US Treasury for reimbursement. The ECB does not sell its bonds at huge losses in the markets. Only The Bank of England does this.

Network Rail plans to rely on taxpayer grant for almost two thirds of its cash needs. Only 4% will come from revenues of its commercial, property and freight interests. It has fabulous land and buildings, with key sites in the centres of our cities and many towns . It fails to develop those and to harness private capital to make more stations good locations to visit with retail and services. It fails to develop land adjacent to stations and rail yards for commercial purposes.

Nationalised HS 2 was a spectacular failure at building the original northern rail scheme to something like budget and timetable . It is ending up building us a ridiculously costly additional London to Birmingham line when improved signalling and by pass track would have been a much cheaper answer to any capacity issues.