Controlling debt interest

The apparent cost of UK debt interest has shot up in the last two years. Some of this is the result of the state continuing to borrow a lot more on top of a large established debt. Some of it is the extra cost of the new borrowing now interest rates have gone up. These issues need addressing by a mixture of more revenue from faster growth and less spending on various programmes as often outlined here.

There are however other large elements in the interest bubble that depend on the accounting conventions and the strange decisions made about bond purchases and sales by the Bank and Treasury. The index linked debt entails paying cash interest payments as with normal government bonds and these are properly annual expenditure. There is then the need to repay the inflated value of the bonds on redemption, where there is no cash outflow until the date of repayment. In practice the government just borrows the inflated value back again without ever having to pay out of running revenues. This should be a contingent capital liability.

The large amount of gilts held by the Bank of England are no longer a debt of the state to the private sector but a debt to itself. Here the government indemnifies the Bank against losses, so the Treasury is currently incurring losses it has to make good every time the Bank sells one of these bonds at a large loss in the market. These costs could be cut if the Bank stopped selling the bonds, waiting instead for their repayment when the losses would be smaller.

The Treasury also pays the Bank for running losses. The Bank pays out more interest to commercial banks on the deposits they hold with it, than it gets in interest on all the bonds it holds. It deliberately bought these bonds at very high prices offering very low income, making this problem worse. The OBR reckons every increase in the Bank’s bank rate increases government interest costs by £10.8bn.

The European Central Bank, faced with similar problems of large losses on bond capital values sells fewer of them than the Bank of England. Facing running losses, the ECB has recently announced that from September commercial banks will not receive any interest on the reserve deposits they have to place with the ECB, eliminating much of the loss on holding low income yielding bonds.

The UK government needs to get Treasury and Bank here to review its current practice with a view to getting material reductions in the apparent costs of debt interest. That would give the Treasury more flexibility to set out a growth strategy to start growing the revenues faster. This is one occasion when copying an EU idea could help.