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.

Energy prices and markets

On Monday we will be asked in Parliament to approve a comprehensive set of powers for government to set maximum consumer prices for energy, to send large subsidies to energy suppliers who have to sell below cost and to remove surplus revenues from producers of electricity selling well above cost.

Of course we need to look after people who cannot afford their energy bills and need to offset some of the big hit to consumers generally. The energy price rise is like a massive tax rise.

We also need to be careful not to stop companies investing in new capacity or deter big users of power from seeking to improve their energy efficiency and reduce their use. We also need to keep the cost to taxpayers down where possible.

I would be interested in your thoughts on if there could be a cheaper and less all commanding scheme that would work?

You were right first time PM

The Prime Minister was right to want to keep the UK corporation tax rate at the lower end of the advanced countries tax table. We need to carry on attracting large investment flows into our country and leaving domestic businesses with more of their profits to put into new investment.

It appears the PM has been persuaded to row back on this promise of her election campaign to "ensure economic stability". I do not think this measure does that. After the 2.30 announcement yesterday there was a sharp sell off in long bonds. Interest rates on the 50 year paper rose by more than 0.4% or

40 basis points. As the PM's critics wrongly think the UK bond markets currently move on changes of government policy they need to explain why when the PM did the main thing they wanted the bonds sold off sharply. Maybe long bond movements in recent days have more to do with Bank of England management of the market.

Sterling was unchanged after the announcement instead of rising as her critics implied.

Instead of changing individual items in the tax proposals the new Treasury team needs to bring forward the spending proposals and show us forecasts of the deficit. We need a menu of tax and spend options with prices to influence and judge the full budget and fleshed out growth plan. The PM promised MPs a series of meetings and consultations over the next week preparatory to the full budget. These talks need the government to keep open tax cuts as well as increased spending on priorities and cuts elsewhere. If they have already taken the key decisions the talks are pointless.

I am all in favour of actions to get the deficit down.I have been forecasting a higher deficit this year than the £99 bn OBR budget estimate. To control it I would look first as the biggest change by far that the new PM has announced, the energy package. It should remain very supportive for people on low incomes, but there could be more burden sharing for higher earners who burn a lot more fuel.

Taxing times

Bizarre to hear the media and Opposition mobs out to pull down the PM by forcing her to tear up her pledge to keep the UK competitive on business tax rates.

As always the Opposition wants to do the EU's dirty work to make us less competitive and get in the way of us attracting more business investment and more jobs.

The think tanks and forecasters who want taxes up tell us the deficit will otherwise be too big. If they have their way they will put us into a longer and deeper downturn which will mean a higher deficit, not a lower.

Over the last 2 years the OBR has massively over forecast the budget deficit and used these wrong forecasts to push a Chancellor into higher taxes. More accurate forecasting would conclude now that a lower business tax rate would be better for growth and for total tax revenue.

Onshore gas

The government has said it is considering allowing extraction of onshore gas in the UK subject to community consent and full safety and planning controls. Critics of this approach call it fracking, which is a description of some reservoir management techniques that have been commonly used in oil and gas wells for many years and have been accepted as safe. In order to sustain or increase pressure in some oil and gas deposits so the gas and oil flow to the surface it is necessary to inject agents, most often water, to increase pressure in the strata to move the gas on. There could be low level seismic shocks from this process which produce little or no disturbance at the surface above the reservoir. These shocks are monitored and controlled, and are usually below the level of shock created by a bus going by on a nearby road, or felt near to a building site.

Producing more of our own gas would be good for the environment and good for our economy. It would more than halve the CO_2 output compared to relying as we do today on too much imported LNG gas. These imports need energy to compress, liquefy, transport and convert back to gas which we do not need for home produced gas. Imported gas attracts large tax revenues which are paid away to a foreign country, whereas home produced gas would be taxed to help pay for local services. Home production brings well paid jobs . Home produced gas would likely to be sold as contract gas, avoiding the price spikes of buying gas on a volatile world market. It would ease our indirect dependence on Russian gas into Europe.

I also think it fundamental that work on such a gas well should only go ahead where the local community affected by it has given consent and participates in the revenue or uses some of the gas produced. I would not want a gas well close to a town or village in my constituency where the public did not wish one. The idea behind requiring community consent would be to encourage wells and drilling well away from homes. People should have the choice, and some may well wish to allow drilling a mile or two away from their home in return for payments from the producers. This policy is currently being consulted on and is not firm, so your ideas would be especially welcome.