Funding the Future

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People have been asking me to write a glossary entry on bonds. This is my draft. Comments are welcome.

Background

There is much confusion amongst many people about what the financial instruments that are called bonds might be. This glossary entry seeks to explain some of the issues, without entering into excessive depth.

Bonds

A bond is a promise to pay. The value of the bond represents a sum of money, called the principal, that is entrusted by a person (the bondholder) to an organisation (the bond issuer) for a fixed period of time in return for a predetermined rate of interest, usually called the coupon rate. During the life of the bond, the holder receives this fixed rate of return, usually paid once or twice a year. At the end of the agreed term, or at maturity, as it is called, the principal is repaid in full.

That describes the simple version of the bond. However, bonds come in many forms, and their economic meaning depends entirely on who issues them and why.

Who issues bonds – and why it matters

When a government or a large company issues a bond, it is normally quoted on a financial market. This means it can be bought and sold after issue, and its current market price will vary depending on the supply and demand for the bond amongst savers seeking to own it.

In contrast, when a bank or building society offers what it calls a “bond,” it is not a bond in this sense at all. It is simply a fixed-term deposit, or a savings account with a fixed interest rate and a fixed term. It cannot be traded. It is not quoted on any market. It is a savings product dressed up in grander financial language.

That distinction matters because people often assume that all “bonds” are alike. They are not. A tradable bond is a financial asset with a fluctuating market value. A bank “bond” is just money on deposit.

The basic structure

In its purest form, a bond promises two things:

* To pay a fixed rate of interest, the coupon, over the bond’s lifetime.
* To repay the original principal at maturity.

A bond issued at £100 with a 4% coupon will pay £4 a year, every year, until maturity, when the £100 is repaid. The government or company that issued it must meet those obligations, come what may.

Index-linked bonds

That said, not all bonds have fixed returns. Some are index-linked, meaning that either the interest payments, the principal, or both, are adjusted in line with inflation.

In the UK, index-linked government bonds, or “linkers” as they are often called, are adjusted by reference to the Retail Prices Index (RPI) or, more recently, the Consumer Prices Index (CPI). The purpose is to protect investors from inflation by maintaining the real value of their investment.

If inflation rises by 5%, both the interest payment and the value of the bond increase by 5%. This gives holders security, but it also means that when inflation spikes, the government’s recorded cost of so-called “debt interest” surges, even though little new cash has actually left the Treasury. What has changed is the future obligation to repay the bond on maturity, which might now be more expensive.

This point is routinely misunderstood. When inflation was high in 2022 and 2023, the government’s reported “borrowing costs” appeared to explode. In reality, most of that was the mechanical consequence of indexation on existing bonds, and not a rise in new interest payments.

The market price and yield

The coupon on a quoted bond, say, £4 on a £100 bond, never changes. But the market price of the bond can.

If investors come to expect higher interest rates in the economy as a whole, new bonds will be issued with higher coupons. The old 4% bond then looks less attractive, so its market price falls. A new buyer might only be willing to pay £80 for it. That means the £4 coupon now represents, in simplistic terms (ignoring the time to maturity), a yield of 5% (£4/£80).

If interest rates fall, the opposite happens. The fixed £4 payment looks generous, so buyers are willing to pay more, perhaps £120. The yield therefore falls to 3.33% (£4/£120), again calculated simplistically, which is sufficient for these purposes.

This simple demonstration of changes in value relating to expected interest yield demonstrates the inverse relationship between price and yield. When bond prices go down, yields go up, and vice versa. The key point is that the government's cost does not change. It is still paying the same £4 coupon. What moves is the market's valuation of existing bonds.

To be clear about this, the "interest rate on government debt" reported in the press is not usually the rate the government is paying. It is the market's yield on bonds already in circulation. That yield is a snapshot of what buyers and sellers think those fixed future payments are worth at that moment.

The function of bonds in the modern monetary system

This leads to the biggest misunderstanding of all: that governments issue bonds to fund their spending.

They do not. In a country with its own currency that is widely accepted, and in which its debt is denominated, and with its own central bank, as the UK has, all government spending is funded by the creation of new money by that central bank, which in the UK is the Bank of England. The government instructs its bank to make payments; the bank credits the relevant private-sector accounts, and new money is created in the process. The government's overdraft with the Bank of England is increased as a result.

Taxes then remove most of that money from circulation in the economy by reclaiming it for the government that spent it in the first place. Bonds are then issued to provide a safe home, or a savings account by any other name, for whatever remains in the economy after tax has been paid out of the money the government created. What should be clear, then, is that the government issues bonds solely to mop up the excess money supply it has created and left in the economy after taxes have been paid. This process does not fund its spending: it does instead balance its money creation process, although whether that is technically necessary is another issue altogether, not considered here.

In that case, government bonds are nothing more than savings accounts at the Bank of England, held by pension funds, banks, insurance companies, and other financial institutions, inclduing foreign governments and banks who want a convenient way to hold sterling. They pay interest, they are safe, and they can be traded through the financial markets, all of which show what they are really for: which is to manage liquidity (or safe cash availability) in the banking and financial services system by providing the financial sector with risk-free savings accounts in which they can deposit their excess funds, which were created in the first instance by the government.

To call them “borrowing” is, therefore, misleading. The government does not need to borrow the money it itself creates. It simply offers the private sector an interest-bearing place to store that money safely.

The political and economic confusion

Because bonds are called “government debt,” it is easy to assume they represent a burden on future generations. In truth, they represent wealth in the form of savings held by those who own them. Every pound of “debt” is someone else’s asset.

If you hold a government bond, you do not fear repayment. You rely on it. Pension funds depend on gilts precisely because they are the safest assets in existence.

When politicians claim the government must “tighten its belt” because of high “borrowing,” what they really mean is that they would prefer to shrink the size of government and so offer fewer bonds. It has nothing to do with the government’s actual capacity to spend.

The reality

Bonds are, quite simply, the plumbing of the modern monetary system. They manage savings, stabilise markets, and provide benchmarks for interest rates. They are not borrowing in any meaningful sense.

The government does not need your money before it can spend. It spends first, taxes later, and offers bonds to absorb the difference. Those bonds are savings deposits by another name.

To describe them as debt is to mistake the government’s capacity for credit creation for a household budget. And that, as with so much else in economics, is a category error that has done immense political harm.

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