

Why does the government feel bound to serve the bond ma.

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John Fairhall [asked this question](#) on the blog yesterday in response to my post on bond sales feeding off themselves (and I have edited it slightly):

Thanks for the post and the infographics.

I am being extremely dense, so excuse me.

I get that buy a government bond 30 years at 6%, that's a steady fixed rate of interest for 30 years. When it matures I get my money back.

If interest rates go to say 10% on the face of it I should sell and try to buy the 10% government bond.

I may not be able to sell my bond for my cost price (say £1bn) and make a loss of say £300mn. If this is my only capital is not a sensible strategy. I need to keep my capital. So I sit it out.

What I find difficult grasping is how does the secondary market in government bonds affect interest rates when no new money is being " created"?

To me it seems to be just "clever financial stuff" that makes a lot of money for the City. With the usual City risk of no one has any idea what is going on and there will be crisis at some point.

Why should the UK issue new government bonds at a higher rate of interest due the secondary market swings, when it can just sit the "game" out?

Has the UK government committed to a policy that is daft?

I have been asked to share my response more widely, as some people thought it was useful. This is what I wrote, although I have expanded one section here to emphasise the choice that the government can make:

You are not being dense. You have asked an important question about the government bond market.

Your understanding of your 30-year bond is correct. If you hold it to maturity, you receive the promised interest and your capital back, assuming the government honours its obligations. What happens to its market price in the meantime need not concern you.

The secondary market is different. Existing bonds are traded between investors, and their prices change according to what buyers are prepared to pay. When prices fall, the yield to someone buying those bonds rises. No new government money is created by that transaction. It is simply a transfer of an existing financial asset.

The problem arises because the government uses secondary-market yields as a benchmark when issuing new bonds. Investors will not normally buy a new bond offering substantially less than they can obtain on an equivalent existing bond. The government is therefore asked to offer higher yields on new issues.

But your final question is the crucial one. Why must the government accept those terms?

The answer is that it does not have to, as a matter of monetary necessity. Government spending creates money. Bond issuance then offers savers an alternative way of holding financial wealth. The government does not need to obtain money from bondholders before it can spend.

The UK has **chosen** institutional arrangements that link government financing to bond issuance and market pricing. Those arrangements could be changed, although doing so would require decisions about monetary policy, interest rates and inflation management. In particular, the government could decide not to issue bonds when interest rates are too high and borrow from the Bank of England instead, waiting for a more orderly market before issuing bonds again. Technically, nothing stops it from doing that. It does not do so by political choice alone.

So you have identified the fundamental issue. Why should the cost of government financing be dictated by secondary-market transactions when the government is the issuer of the currency in which those bonds are denominated?

That is exactly the question I think we should be asking. The government is not bound by the bond market. Since 1981, when Sir Geoffrey Howe, Thatcher's then Chancellor, introduced the so-called full funding rule, it has chosen to be so, but that decision could be revoked. The question is: why isn't that being done now?