
'Heads I win, tails I win' way to seek higher yields

Sir, Long-term real interest rates are low all over the world, but nowhere are they as low as in the UK. On January 11 2006, index-linked UK gilts maturing in 2024, 2035 and 2055 had real yields of, respectively, 1.10 per cent, 0.87 per cent and 0.67 per cent. In addition, the break-even inflation rates for these securities are anomalously high: 2.85 per cent for the 2024 vintage, for instance.

These anomalously low real yields are not a source of joy, except for those who can borrow at them. Conventional assessments of defined-benefit pension fund solvency will produce staggering shortfalls when future real pension commitments are discounted at such extremely low rates, driving many of these funds to unnecessary and costly defensive actions. New retirees whose retirement plan includes a lump sum that must be used to buy an annuity will suffer a huge reduction in their retirement income.

To overcome this anomaly, I propose that the government instruct the Office of Debt Management to refinance most of the outstanding stock of UK sovereign debt. In particular, it should retire most of the nominal gilts outstanding, at all maturities, as well as index-linked gilts with maturities less than 10 years, financing these purchases by sales of index-linked gilts with maturities of at least 15 years, with preference given to very long maturities - 30 and 50 years.

The DMO could even introduce an index-linked perpetuity or real consol. Future government deficits should also be financed by issuing long-maturity debt for as long as the interest-rate anomaly persists. If all else fails, the government could issue further long-dated real bonds and invest the proceeds in a broadly based portfolio of domestic and foreign securities.

At worst, there is no anomaly, financial markets are efficient and relative supplies of financial securities have no effect on anything. In that case, no harm is done. If there is an anomaly and this strategy raises long rates to less anomalous levels, pension funds and new annuity purchasers will be pleased.

If there is an anomaly but long real yields do not rise, the government will have done the UK taxpayers a favour by reducing future debt-servicing costs.

"Heads I win, tails I win" opportunities in public finance are rare. This one should not be wasted.

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