Official response to low yields is like hunting tigers with pea-shooter
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From Prof Willem H. Buiter.

Sir, The real yield on index-linked 50-year gilts fell to 0.38 per cent last week. This week the response from the Debt Management Office and Treasury came in the form of the issuance of £650m (face value) worth of 50-year index-linked gilts, at a real yield of 0.46 per cent.

The issue represents 0.1 per cent of the outstanding UK national debt and less than 1 per cent of the minimal amount of gilts issuance during the current year - about £70bn worth of maturing debt and new deficit financing. As a supply-side response to the market anomaly of extraordinarily low real yields, this is the equivalent of going on a tiger hunt armed with nothing but a smile and a pea-shooter.

At the very least the authorities should have made a public statement that they will continue the issuance of additional long-dated index-linked gilts until real long rates are at less distorted levels. Should this involve issuing new long-dated real gilts beyond this year's £70bn worth of refinancing and new deficit financing, there are two options.

The first is to refinance part of the existing stock of shorter-maturity gilts. If the authorities wish to remain present in the market for sterling debt at all maturities, short and long, in sufficient quantities to set credible benchmarks, the proceeds from long-dated real gilts issuance this year in excess of £70bn could be invested in a diversified global portfolio - earning a return for the British taxpayer.

Such supply measures will not hurt and may well help, but a lasting solution to the low long real rate anomaly will require measures to curtail the insatiable and damaging appetite of defined-benefit occupational pension schemes and life assurance companies for long-dated real gilts, regardless of their yield.

Formally there is nothing in the laws or regulations governing defined-benefit pension schemes requiring them to put an ever-greater share of their financial assets in long-dated gilts. However, the response of defined-benefit pension fund managers, trustees and advisers to the minimum funding requirement and to Financial Reporting Standard 17 has been frantic, lemming-like liability matching.

This has been reinforced by the creation of the Pension Protection Fund. While asset allocation is not taken into account in assessing the 2006-07 levy by the PPF, there will be consultation on asset allocation as a risk factor. Not surprisingly, this has reinforced the flight to the spurious safety of long-dated index-linked gilts.

The interest rate used to discount future pension fund commitments for financial reporting and regulatory actuarial exercises should have no bearing on the way the assets of the fund are invested. Pension fund managers, trustees and advisers should be mandated to seek the highest long-term return on their financial assets and they should face incentives to do so.

It ought to be a dereliction of fiduciary duty to invest a disproportionate share of fund assets in financial instruments yielding the low real returns we are seeing in the long-dated index-linked gilt markets today. The only certainty provided by these investments is the certainty that they will not support adequate future pensions.