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Indexed gilts

In his Budget speech the Chancellor of the Exchequer announced a first issue of marketable index-linked Treasury ('gilt-edged') stock. This article describes the new stock, explains the background to the decision to issue it and discusses some of the implications for monetary control, the capital markets and the pensions industry.

Characteristics of the stock

An offer of £1 billion of the new stock was made to the market on 27 March, with a maturity of 15 years and a coupon (interest rate) of 2 per cent. This figure was chosen as being within a range of actuarial assumptions about future real returns on gilt-edged stock, but since the stock is sold by auction this in itself carries no implications for its real yield.

The value of the principal on repayment will be related to the movement in the retail prices index (RPI) over the life of the stock. The 2 per cent interest coupon will be paid in two six-monthly instalments, each of which will amount to £1 multiplied by the ratio of the current index figure to the index figure at the date of issue.

The RPI level used to calculate an individual interest payment is that current 8 months before the date of the payment. The advantage of this lag is that at the start of each six-month trading period the money value of the interest payment falling in that period is known. To take a simplified example, if the inflation rate in the first year were to be 10 per cent, then the first interest payment per £100 nominal in the *second* year of the stock's life would be £1 multiplied by 1.1, the ratio of the new RPI figure to the old.

Like conventional gilts, but unlike the indexed National Savings instruments introduced in recent years, the indexed gilt is marketable, and is traded on the stock market. But an unusual feature of the stock is that eligibility to hold it is restricted essentially to pension funds, and to life insurance companies and friendly societies in respect of their UK pension business only. An institution wishing to purchase the stock must sign a statutory declaration to the effect that it is an eligible holder within the terms of the prospectus. The stock may only be bought and sold by eligible holders. The reasons for this restriction are discussed later.

A further distinguishing feature is the method of issue. For new issues of conventional gilts, the Bank of England announces a minimum tender price below which bids will not be accepted, in line with market prices on similar stocks. But the new indexed stock was sold by auction with no announced minimum price, though there was provision for less than the whole amount to be allotted if, for example, it was not subscribed at a price acceptable to the Treasury. It was left to the market to determine the appropriate yield. The prospectus specified, however, that as with conventional gilts, allotments of stock would be made at one striking price and not at the prices actually bid, even when these were higher.

In the event, the issue was oversubscribed on application, and the whole £1 billion was sold at a price of par (100). The stock was £35 per cent payable on application with calls of £30 per cent on 1 May and the balance of the purchase money due on 26 May. The price of par means that if held to maturity the stock will yield a real return of around 2 per cent. (It is reasonable to ignore the effect of the lagged method of indexing interest payments in calculating the redemption value.) In the course of its life the yield will vary along with market conditions in the normal way. The price will be sensitive to changing market views on future real interest rates.

The case for indexed gilts

There has been a long and lively debate in Britain and elsewhere about the merits and demerits of indexed debt instruments. Some have argued that indexation 'institutionalises' inflation: the more people whose financial assets are protected against inflation the more an economy's incentive and ability to contain inflationary shocks is reduced. Furthermore, it is claimed that indexed gilts will be an expensive form of borrowing if inflation is high, and a profligate Government could thereby store up problems for future generations.

Against this, others point to the apparent illogicality of a Government committed to a sustained reduction of inflation continuing to issue high coupon long-dated gilts, which could prove very expensive in real terms, and maintain that indexation will, by reducing uncertainty about future

real returns, allow lower interest rates in the economy generally. Far from encouraging a Government to spend, indexed borrowing imposes discipline, in that it becomes less easy for a Government to inflate as a way of resolving immediate difficulties.

It is true that, in contrast with long-run historical performance, the real return on conventional gilts has been negative over the past decade, because inflation has been higher than expected. But cheap borrowing of this kind could be achieved in future only by permitting progressively higher rates of inflation. Chapter 17 of the Wilson Committee report set out these arguments for indexed gilts persuasively, though the committee as a whole did not make a firm recommendation.

After careful analysis of the economic case, and the implications for other borrowers, the Government decided that it would, on balance, be right to issue indexed gilts, for two principal reasons:

- There should be **improvements in monetary control**. The possession of a new debt instrument of this kind will give the Bank of England additional flexibility in its debt marketing operations. Both conventional fixed-interest and indexed gilts will remain on offer, and this will enable the Bank to match more closely the preferences of investors. Indexed gilts will be saleable at times of uncertainty about inflation without the need to raise nominal interest rates. This reduces the Government's vulnerability to surges of growth in sterling M3.
- With conventional gilts substantial risks are incurred by both investors and the Exchequer, owing to uncertainty about future rates of inflation. An indexed gilt **eliminates these risks**. Moreover, investors should be prepared to accept a lower real rate of interest in return for insurance against inflation. This factor in itself can be expected to reduce the overall cost of servicing government debt.

For these reasons, and because of the positive impact on expectations – only a Government committed to a sustained reduction in inflation would wish to issue them – the introduction of indexed gilts, should allow the Government to achieve a given monetary target with interest rates at somewhat lower levels than would otherwise be necessary, reducing the cost of conventional funding and having beneficial effects throughout the economy.

Market implications

These economic considerations, however, leave a number of practical questions unanswered. Three types of concern have become evident in the weeks since the announcement.

- First, in the light of the advantages of indexation explained above, why has the Government issued indexed gilts in a form which restricts the eligibility to hold them to a particular class of investor – the long-term institutions – and why does it plan to continue also to issue fixed-interest stock?
- Second, what will be the effect of indexed gilts on the pensions industry?
- And, third, what will be the impact on other borrowers – particularly companies – who might not be in a position to compete for funds by offering indexed debt of their own, and might find themselves disadvantaged as a result?

One major reason for **limiting eligibility** in this way was noted in the Wilson Committee report (paragraph 856). At present, the tax system does not distinguish between real capital gains and those arising from inflation-related capital revaluations. With only 'gross' (ie non tax-paying) funds eligible to hold the stock, it is not necessary to attempt to do so. Furthermore, as the Chancellor pointed out in his Budget statement, a consequence of the restriction to institutions carrying on pension business in the UK will be to remove the risk of unwanted large-scale inflows of foreign funds, which might be attracted by the existence of an asset with characteristics not available in other major industrialised countries.

While the impetus for the introduction of indexed gilts came from an analysis of the potential monetary effects and improvements in the Government's funding techniques, there is no doubt that it will in time have significant effects on the **pensions industry**. Although the Scott report on the value of pensions put most emphasis on the potential role of indexed gilts in the valuation of benefits, it also suggested that their existence would enable inflation protection to be extended to the pension arrangements of the self-employed and those not covered by occupational schemes.

It is far too soon to predict how the generality of funds will adapt to the availability of such an asset – and one issue of £1 billion is clearly inadequate to prompt a major change – but over time the private sector pensions industry will gain an additional element of flexibility in tailoring the benefits it can offer. Some companies have already begun to offer index-linked retirement annuities for the self-employed.

The third important question concerns the effect on **other borrowers**. It has been argued that, hitherto, the assets which have been most nearly indexed are, apart from property, company shares, in that a company's earning power should to some extent at least rise with inflation. If the introduction of indexed gilts caused the institutions to switch money out of equities and into the new gilt, then share prices could be depressed as a result.

In the event, this has not occurred. So far, the volume on issue has more or less matched the normal inflows into gilts from the eligible institutions over the relevant period. Also, index-linked stock is not issued *in addition* to the volume of conventional gilts which would have been issued otherwise, but rather replaces issues of conventional gilts. Its introduction has no implications for the volume of public sector debt.

Companies will therefore benefit from the overall reduction in interest rates, so that even if equity prices were marginally reduced their cost of capital would still go down. It should be noted, also, that companies are at liberty to offer indexed debt themselves if they so wish, and the tax implications need not be disadvantageous.

Market reaction to the new stock has been favourable. The oversubscription of the first issue showed that there is considerable demand from the eligible institutions. The Government said at the time of the announcement that further issues of indexed stock would be made if the first was a success. This condition has been fulfilled.