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The Savings Paradox or Managing Financial, Economic or Fiscal Risks

Drs Kees de Koning, 21st July 2012

Executive Summary

The savings paradox: that savers can (and do) take short term actions which harm their long term interests. This paper will examine savers' behaviour and particularly why they cash in their assets when faced with real or apparent risks, and consequently damage their net worth. Individuals cannot help themselves in overcoming this paradox, and therefore how governments can help will also be examined.

Savers' savings are exposed to risks: risks to yields (the cash flow rewards for postponing consumption) and risks to values (the risks to the principal amounts saved). In this paper, what is meant by savings is the accumulation of incomes not spent, ie a person's net worth. Individual savers rarely have a direct say in which risks their savings are exposed to; companies, banks, asset managers, pension fund managers and even governments take risks on their behalf. However, savers have one key weapon in their artillery which makes everyone listen: they can choose to move their savings away from risks which harm their net worth. They could do this, for example, by moving their money away from riskier investment products based on yields to products which are based on the lowest risk to value, such as some government bonds. Regretfully for savers, their short term actions in doing this do more harm than good. Assets like homes, company shares and government's bonds - the main assets in which savings may have been converted - cannot be converted back quickly into cash. If savers try to do this, losses will be multiplied rather than reduced. As individuals cannot solve this paradox, the solutions could be found in introducing collective risk management (CRM) methods.

Two elements about savings stand out. Firstly, savings (the net worth of households) have reached levels which are four or more times GDP; and secondly, savings are truly global. Individuals often hold their net worth with managers who are international in nature, such as banks, asset managers and pension funds. Therefore collective risk management methods should be more focussed on savings than on GDP, and also on getting governments to act more in cooperation with one another. Savers can be a force for good to economies, but equally a force to harm economic growth and employment levels.

Collective risk management needs a CEO, a Minister (or Secretary) for Savings. The Minister should be independent from Government as governments themselves can be the cause of increased risks to savers. However, independence from Government does not imply independence from parliaments. The Minister's actions should be based on assessments of the collective risks to savers, and can - and should - be sanctioned by parliaments. They can be preventive, but also curative measures.

Some examples. Worldwide, the Ministers of Savings would have noted that government debt is a type of consumer debt which depends on economic growth, employment levels and incomes. Therefore parliaments should choose to set the long term government bond yield, balancing taxpayers' interests against savers' interests. In the U.S., when faced with the subprime mortgage crisis, the Secretary for Savings could have imposed a rule on the risk originators to guarantee the doubtful credit risks.

For the Eurozone, the Ministers of Savings would agree that "cash flights to safety" by savers represent liquidation pricing, ie savers move their monies to protect the value of their net worth in a "fire sale". The seven countries with the lowest real bond interest rates could raise funds from the markets; not for government expenditure, but for financial risk management purposes. They could deposit these funds with the ECB which in turn could buy the bonds of the other 10 countries, thereby lowering their yields. All countries would benefit. In Spain, the Minister for Savings would have noted that the 800,000 unsold homes are the problem which has subsequently caused the banking problems. This paper suggests that one way of easing this housing issue would be to sell the homes to northern Europeans, offering them a subsidy for purchase, rather than bailing out the Spanish banks.

In other countries like the U.K., the U.S., the Netherlands and Canada, in order to manage the collective risks, the Ministers of Savings would have the option to stimulate economic growth by using the help of the pension funds and life insurance companies. Here, the Keynes method of channelling extra borrowing into government expenditure is no longer an option. A "pension dividend" of about 2% of GDP could be handed out - tax free - directly to the pension savers and pensioners on an equal basis. Once growth rates are up and running, tax payers could gradually reimburse the pension funds etc for the loss of pension reserves. For countries in the Eurozone, without large pension savings, the same effect could be reached by using funds from the European Financial Stability Facility for countries like Spain and Italy.

The Savings Paradox or Managing Financial, Economic or Fiscal Risks by Drs. Kees de Koning

1. Savings

Long term savings are the bloodstream and oxygen to modern day economies. Just like in our bodies, such savings need to be nurtured, otherwise arteries get clogged up and heart attacks or other diseases may occur.

Households have accumulated savings over long periods of time. To give a few examples: in the U.S., according to the Federal Reserve, the combined net worth of households, after deducting their borrowings, stood at US\$ 62.9 trillion per the end of March 2012. This level of savings represented precisely four times U.S. GDP of US\$ 15.5 trillion. For most U.S. households the prime source of wealth is their family home. In the U.K., a Lloyds Bank study estimates the U.K. household net worth at £6.6 trillion per the end of 2011. Of this amount £2.6 trillion is the net values of homes and £4 trillion the financial assets. With 2011 U.K. GDP at £1.55 trillion these savings represent four and a quarter times the 2011 U.K. GDP levels.

The banking sector in their mortgage businesses convert short term client deposits into long term funding for home and other real estate acquisitions. They also convert short term client deposits into funding of government bonds. Banks are main contributors to asset conversion from cash into assets. Short term cash holdings become long term asset class commitments.

Savings have become an international business. One has just to think of pension funds moving into asset classes overseas or Swiss banks helping their client base to seek long term investments for the clients' savings not in Switzerland, but around the world. Other examples are multinational companies which have their shares listed in several countries and cash flows coming in from many places in the world. In the Eurozone, the movement of savings between the 17 countries has been made easier as they share a common currency. Some countries, like Norway and some other oil-exporting countries as well as some far sighted governments, have set up sovereign wealth funds, which by their very nature invest their savings in countries other than their own.

For both short and long term savers the direct control over their savings is nearly always handed over to companies, banks, life insurance companies, pension funds, professional money management companies and also the government. All savers can do is hope that managements of all these institutions treat their savings prudently at reasonable costs. The final choice is one of withdrawing the savings.

Both the financial sector products and the people handling such products – the intermediaries- have grown in complexity over the last 30 years. All kind of risk instruments have been introduced, like currency, credit and commodity derivatives. Also spread betting on share developments, exchange traded funds, synthetic exchange traded funds and share lending practises have been introduced. Pension funds and life insurance companies have long been established to act on behalf of the long term savers. More recently asset management companies, hedge funds, vulture funds, and private equity funds have sprung up. Some of these activities are carried out by the banking sector, others are not. Sometimes banks, through their private banking activities help their clients to get involved in financial or real estate markets.

How important are savings? Governments could not function without them, even if they are able to balance their tax revenues with their expenditure levels in the current year. For the European Union countries, their average government debt obligations -from past expenditure- stood at 82.5% of GDP over 2011. House building would not happen if it were not for savings converted into mortgages to help people buy or rent. Companies could not grow in the same way as they have done if it were not for the stock markets helping them to provide equity.

Since 2008 when bank risks became a major issue, governments have introduced government guarantees for bank deposits for limited amounts. As banks are major holders of government bonds, most taxpayers are guaranteeing themselves for these risks. Perhaps this was not the intended aim of such guarantees.

Regretfully governments' actions on collective risk management for long term savers can only be described as fragmented, uncoordinated and reacting to situations rather than pro-actively anticipating measures to ensure sound long term saving practices.

2. The Savings Paradox

The savings paradox can best be illustrated with a country example: the 2008 U.S. subprime mortgage crisis.

In the U.S. during the few years preceding 2008, mortgage originators started to have mortgages approved by banks on basis of doubtful principles. A Deutsche Bank study came to the conclusion that 37% of the mortgages granted were interest only mortgages; 38% of the mortgages also required no down payment so 100% of the value of the home was borrowed; 43% of the borrowers were not required to provide any proof of income and finally 80% of borrowers were attracted by providing them with a low start up interest rate for a period of two years, after which interest rates were hiked up steeply.

The subprime market segment "only" amounted to U.S\$ 1.2 trillion out of the total home mortgage market of U.S\$ 10 trillion.

U.S. investment banks started to package these subprime mortgages into Collateralised Debt Obligations. Based on AAA ratings from the U.S. credit rating agencies, the investment banks sold these CDO's around the world, but also to U.S. money market funds. When the real risks to these mortgages appeared, as cash flows faltered, the U.S investment banks were in no position to maintain a market in these CDO's., something they had promised to do. The CDO's turned from "going concern" to "liquidation" CDO's. The pricing fell of the cliff and many CDO holders could not get out of the risks: The savings paradox.

The cash flow misjudgements led to value misjudgements. Such liquidation scenario led to repossessions and forced sales of properties in the U.S. The S&P/ Case Shiller home price index dropped from an index value 170 at the end of 2007 till 130 a year later. Banks, apart from lending to their own clients, also lend to each other, as well as trade in risk products. The banks among themselves, as well as the markets, became uncertain which bank had what type of exposure. Interbank lending dried up. It led to bank closures and bank rescues especially in the U.S., the U.K. and some European countries. Credit tightening took place around the world. This led to an overspill into the share markets. The shares dropped on real and perceived company and bank risks. They also spread to the U.S. and other governments, which had to borrow substantial funds to bail out banks and to compensate for lower tax incomes. The U.S. defined benefit schemes saw their asset values drop by 30% in 2008 and they alone lost around \$1 trillion in the same year. As companies guarantee the pension benefits in DB schemes this led to another unwanted side effect, in 2009 U.S. companies maintaining DB schemes were forced to set aside U.S\$ 90 billion compared to U.S\$ 45 billion in 2008, a doubling of contributions in times of recession. The "oil spill" effects of the subprime mortgage debacle had serious effects on the long term savers, but also on the real economies throughout the world through lower or negative economic growth rates with higher unemployment rates, bank lending restrictions or contractions, a drop in company sales levels and increased government deficit levels. The original loss on cash flows from subprime mortgages was multiplied many times over in the financial markets and the real economies.

Were markets right in assessing that home prices dropped by 24% in a year in the U.S in 2008 and that the Dow Jones industrial index dropped by just over 40% from October 2007 till October 2008? My conclusion is that market prices for real estate and shares were driven by savers, in panic, trying to get out of risks in the short run by forcing through real estate and share sales. Such panic share pricing did not reflect the net present values of the future profits of companies. In the real estate markets the net present values of future rental incomes did not warrant a 24% drop in house prices in a year. Through short term desires by savers to get out of assets and into cash -liquidation pricing- the real estate and the share markets got their pricing for these asset classes wrong. The long term price -the going concern price- based on net present values of future incomes and the short term prices based on liquidation scenarios deviated: the savings paradox. Liquidation price setting is harmful for all participants in the economic process, be they workers, employers or a government, but such pricing is especially harmful to economic growth and to savers as the price setting

leads to unjustified economic contractions in bank lending, in house building and in company investments. It also leads to wrong assessments about the adequacy of pension reserves. In the still operating DB schemes, or in the non-funded government employee schemes, it means that companies or the taxpayers have to pick up the tab for additional money injections, taking money away from investments or from funding normal government expenditure.

If the U.S. government would have had a Secretary of Savings in 2006 or 2007, the Secretary would certainly have known about doubtful lending practises and would have placed such risks to long term savers squarely on the heads of the mortgage originators and mortgage sellers, like the investment banks. By instructing them to provide credit guarantees for their products, their absorption capacity would soon have run out and the subsequent losses would have stayed with them rather than having been transferred to savers worldwide. The losses would also have been much reduced. The crisis would have been less severe.

3. Managing Financial, Economic and Fiscal Risks

3.1 Key points

The flaws in the U.S. subprime mortgage lending debacle could not have been cured by legislation. The flaws were in the type of risk taking and in the transfer process from risk originators to long term savers. The direct link between fund providers and fund users was broken by packaging the risks. Companies, generally speaking, cannot or will not transfer their production risks to others as they own the know-how on which these production processes are based. In the financial markets risk transfers have reached very high levels, much of it is based on speculation. Because the “product” involved deals in money savings, authorities have been more hesitant in managing the risks.

The risks in the Spanish housing market crises, where 800 000 dwellings were built for which there are no buyers, stayed with the banks involved and these banks need to be saved. If these banks were allowed to go under, savers would be punished for actions by bank managements over which they had no influence or control. If current plans for foreign funding for Spanish bank rescues get under way, either the Spanish taxpayers or the foreign taxpayers become the ultimate risk takers. Spanish bank rescues do not solve the overhang of 800 000 unoccupied dwellings in Spain. In Section 3.2 an alternative solution is provided.

Given the size of private accumulated savings as compared to GDP and the damage to wealth and economies which can be brought about by a lack of collective risk management, it is somewhat surprising that governments have not seen it fit to appoint a Minister for Savings. His/her job should be to anticipate and manage risks occurring from actions affecting real estate prices, share prices and government bond yields. Managing risks means an active form of management. Law making is a very small component of it. Analyzing and acting upon short term financial and economic threats to savings are the keys in helping to get the balance right between savers actions in the short term and savers interests in the long term.. Currently helping economies to return to a “going concern” mode is needed. In the next few sections suggestions are made which may help to do this.

3.2 The case of Spain

In Spain, the cause of its current crisis has very little to do with the Euro as a currency or with the Spanish government acting imprudently, but all to do with some banks turning savings into 800 000 homes which could not be sold to potential buyers. What other European governments might have done to help manage these collective risks from spreading to the Spanish economy and Spanish government is setting up a second home acquisition scheme for their own nationals rather than to lend Euro 100 billion to the Spanish government, or directly to the Spanish banks. The latter injection equates to Euro 125 000 for each unsold home. The unsold home problem could have been solved much more effectively by supporting foreigners in buying homes in Spain from the Spanish banks or population. This could be done with the help of a subsidy. Instead of providing Euro 125 000 per home, give foreigners a subsidy of 20% of the amount i.e. Euro 25000 per home. If the lending is also executed by German, British, French, Dutch, Swiss, Austrian and Scandinavian banks than the inward capital movement into Spain will help solve the real estate crisis, part of the banking crisis and a substantial part of the government debt crisis. The homes should be of a minimal

value of Euro 150 000, which equates to properties of 120 sq meters in the Spanish Mediterranean Coastal provinces. Such potential buyers should themselves put in an amount minimally equal to the governments' injection. The remainder amount should be up to the foreign bank's credit judgment. The buyers should also agree not to sell the properties for a minimum of five years. The Bank of Spain could supervise the scheme. Of course the scheme would be stopped as and when the supply of homes comes nearer to the full utilisation levels.

The consequences: The Spanish property markets will turn around pretty quickly; a place in the sun is still a dream for many Northern Europeans. The Spanish banks will be relieved from their property overhang on which no cash flow is received while their borrowings still carry interest costs. The Spanish people who sell and move to other properties will usually have more cash available as 50% of homes are owned in Spain without a mortgage. European governments usually operate either capital gains taxes or income taxes on second properties, so they will get their money back in due course. Last but not least the capital inflows into Spain and the strengthening of the banking sector plus the additional tourist incomes will help the Spanish economy to turn around as well. This comes all at a fraction of the costs of the Euro 100 billion. Spanish government bond yields will come down as well. The example is just one of the ways in which understanding the causes of the risks to savers can help devise sound solutions. The "perceived risk" outlook for Spain will fundamentally change by implementing this scheme.

3.3 The choice of government bond yields

Just like real estate markets and share markets, government bond markets also suffer from over- or undershooting. In the government bond markets, the short term movements of savers to take their savings to "safe" havens in times of extreme economic and financial uncertainties, is not based on yields, but on the principle of trying to preserve the principal amount of savings notwithstanding the yield. In the case of government debt, the future cash flows needed to service the debts are based on transfers from the taxpayers to the government. The ability to do so depends on full employment and economic growth. Contrary to savings used for real estate and shares purchasing, which help create growth, government debt funding represents mainly funding past government expenditure: a type of consumer debt obligation. As there is no future cash flow other than an income transfer from the private sector to a government, there is also no natural long term price for such debts. This means that governments need to set such a price. It is therefore surprising that no parliamentary discussions have been taking place about achieving the right balance between savers' and taxpayers interests in setting the long term bond yield.

Three points need to be made in this respect: the first one is that short term savers' actions to move savings to "safe havens" can distort the long term bond yields. Secondly on top of this, governments themselves can further distort long term bond yields by printing money by their central banks and buy up outstanding government bonds. The Weimar Republic example of using the government money printing press to fund past government expenditure should be a clear warning to all governments. Monetary and fiscal prudence is a virtue. Thirdly and last but not least a government is the only entity which can set its own yield for 10 year bonds as well as maintain the yield by buying and selling operations by its central bank. Such stability in long term yields helps all other entities planning their future cash flows. This helps pension funds, life insurance companies, but also the banking sector.

A stable 10 year government bond yield for any government could be set at inflation level plus 2%.

The unique situation for government bond yields of the 17 Eurozone countries, which share the same currency but have different tax levels and various other economic criteria, is discussed in the next section.

In Annex 1 the current U.K. pension situation is described.

3.4 The Eurozone choice for government bond stability

The 17 Eurozone countries share one currency, but each country has a different inflation rate, a different rate of economic growth, a different level of unemployment, a different level of outstanding government debt and a different state of its banking sectors. Managing the gap risks between short and long term savings intentions needs positive government actions.

This could be done as follows: Countries such as Austria, Germany, Belgium, the Netherlands, Luxembourg, France and Finland could attract 10 year funds from the financial markets not for government spending but for financial risk management purposes by depositing these funds as reserves at the ECB. As an example, Germany could use these powers till its borrowing yield would reach 3.9%, 2% over its current inflation level. These savings remain German savings at the ECB. For the other six funding countries their inflation rate plus 2% would also be the yard stick. The ECB could with these funds, subsequently buy up government debt of the 10 countries, provided that they follow the fiscal pact. In these 10 countries the yield has overshot the level of inflation plus 2%. In the case of Spain, which always had a very prudent central government, its inflation rate is, like Germany's, 1.9%, but its yield is 7%. In this example the ECB would buy 10 year Spanish bonds currently at 7% and subsequently at lower yields till the Spanish yield also stands at 3.9%.

The ECB's interest income from Spanish bonds exceeds the borrowing costs of the seven countries. Such interest income will be fully distributed over the funders pro rata of their funding contributions. In this way the costs of issuing more government debt than needed for own government expenditure of the seven countries is more than met by the income from bonds of the 10 countries held by the ECB. For the taxpayers in the seven countries, they have no future tax obligations based on the additional borrowing levels as such borrowings are deposited with ECB. The seven countries can issue more debt, but the funds are not used for domestic expenditure. Fiscal prudence stays intact. The action is aimed at maintaining financial stability across the Eurozone, rather than increasing government expenditure levels in any participating Eurozone country. The interest costs will be met by the real borrowers, the 10 nations. The fund suppliers –the seven nations- get an extra income, while the taxpayers in the 10 countries benefit from the balancing act of the ECB. The ECB does not need to rely on money printing, but can rely on moving real private savings within the Eurozone countries. The risks involved are minimal as the 10 countries can fund their government bond obligations, not on wrongly “perceived risks” but on actual realised risks. By lowering the overall risk level in the Eurozone countries all countries benefit. Of course, the criterion for assisting the 10 countries is that they apply the fiscal pact requirements. Executing such a balancing act has to be done on a daily basis; only the ECB is up to this task. The European Financial Stability Fund cannot operate in the required manner. The financial markets will relish this type of market stabilisation by the ECB and private sector fund flows will soon return directly to the higher paying Eurozone countries, making intervention unnecessary.

3.5 How to stimulate economic growth

3.5.1 The pension fund variety

The traditional manner to stimulate economic growth was the Keynesian method of using private savings to fund government deficit spending in the current year. The traditional manner has most likely reached its limitations for the U.K. and other countries as government debt levels have reached from 80 to over 100% of GDP levels. Another way in which such economic stimulus can be executed is to allow all pension funds and life insurance companies to collectively inject 2% of, for instance, Britain's GDP, equalling £31 billion into the U.K. household sector this year. This amount is less than 2% of the assets held by these funds and companies. In order not to disturb financial markets, the Bank of England could advance these funds to the pension funds and life companies till new cash inflows from pension contributions, dividends and interest flows make up for this amount. Pension funds etc. could distribute such funds –preferably tax free- on an equal amount basis to all pension savers and retirees drawing a pension already- equal to reflect that new savers will have to contribute for a very long time until receiving benefits-. The recipients need to get the message from the U.K. government that it is vital to the economic health of the country to spend the additional income rather than save it. If done, the £ 31 billion will set off the demand pull injection which in the past was funded via the government's deficit creation. Once these savings injections have raised growth rates to, say, 2% per annum, government tax revenues will have increased and out such tax revenues the pension funds etc. could gradually be repaid for their loss of reserves. The costs to taxpayers could be set at CPI plus 2% over the period that the funds were used for creating the economic stimulus. The U.K. Government debt levels will not increase; real savings will be converted into consumption when the economy needs it and the taxpayers will return these savings when economic growth levels have reached the desired level. All sectors of the U.K. economy benefit. It will lead to lower unemployment levels, to higher company outputs and profits, to lower risks for the banking sector and to higher government revenues levels.

It will also lead to improved share prices based on higher company profits. The “pension dividend” method represents a different way of managing collective economic risks. The method could be applied not just in the U.K., but also in The Netherlands, as in the U.S. and in Canada as well. The latter countries all have large amounts of savings accumulated in funded private sector pensions. What is also encouraging is that the pension dividend method can be started up and stopped much more easily than governments can control their extra spending once Keynesian programmes have been formulated and started up.

3.5.2 The transfer of savings variety

In order to get the economies in the 10 Eurozone countries growing again, some may need some help. The European Financial Stability Fund may need to set up for these countries, which lack sizeable funded pension savings, a similar scheme as the pension dividend injection scheme of the U.K. Such facility is an economic loan to foreign taxpayers, to be repaid as and when economic growth rates have reached their targets. Such economic loans should only carry the taxpayers’ guarantees, but not the governments’ ones. For Spain one could think of about 2% of GDP or Euro 35 billion, to be handed out, tax free, to all households on an equal basis, perhaps in semi annual instalments. This injection –an economic easing scheme- might need to be repeated in 2013. Repayments should start when economic growth rates have reached their desired levels. Again governments need to get the message across that spending the received monies is needed to get employment levels up as well as economic growth in the self interest of all concerned. By helping one Eurozone country back to growth and prosperity, it will help all others.

4. Conclusions

The conversion of savings into real estate, government bonds and company shares creates long term time risks on cash flows and values. Individual savers, in order to protect the principal value of their savings, may move away from some assets in the short run. This harms all savers: The savings paradox. Economies go from a going concern mode into a liquidation mode. Such collective risks can only be managed by governments by devising appropriate risk management strategies, like a home buying programme for foreigners buying up the overhang of Spanish properties, like a 10 year bond yield management programme, a pension dividend scheme and an economic easing programme to strengthen economic growth rates. Once private financial markets conclude that risks are well managed, the other risks, such as banking risks become automatically more manageable. Fiscal austerity and economic growth policies can go hand in hand as long as savers feel that their interests are properly looked after and rewarded. DB schemes will become less costly for companies to maintain and funded pension funds will become much more popular as their yields will increase. Over time, the losses on savings will be reduced and economic efficiency enhanced. Even accountants and actuaries can sleep better.

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Annex 1. The case of the U.K.

According to the Pension Protection Fund, in the month of May 2012, the 6432 remaining final salary private sector funds saw their collective deficit grow with UK£ 95 billion or 50% over the previous month. Over the last year till May the total deficit is now 13 times higher than 12 months ago at £ 312 billion. Total assets were £1031 billion and total liabilities £ 1343 billion. 5503 schemes were in deficit and 929 in surplus. On top of the £ 1 trillion in DB schemes, the UK has another £900 billion in DC schemes saved up as per end 2011 according to TheCityUK.

One has to add another savings element to these totals. It is common in the U.K. to buy an annuity from life insurance companies on or near the date of retirement. The life insurance companies in the U.K. are responsible for another £ 1.7 trillion in invested savings assets.

The efforts and government decisions to postpone the retirement age and to widen the level of contributors to pension schemes help in the very long run but do not take away the miserable investment results over the past 13 years. This was highlighted in the OECD Pension Outlook 2012. For future years, the outlook remains poor, unless the U.K. economy gets a boost and unless the Bank of England changes its policy towards the long term yield curve of U.K. government bonds.

For the U.K. the key element for pension funds, but also for life insurance companies and banks is the negative real return on government bonds and indirectly the negative returns on shares as the economy is stalling. One cannot hope for economic growth or for a decent pension if long term savings are not rewarded with positive real interest rates. For U.K. banks, their costs of funds exceed the returns on 10 year U.K. government bonds, so holding these government bonds -supposed to be the safest asset- is a loss making operation, undermining the whole equity structure of U.K. banks. For life insurance companies it means lowering the value of the annuity pay out for people who have saved all their working life for a pension. For the savers it means that saving is not profitable, so they stop saving, while all economic agents need such savings.

All pension savers are taxpayers, but not all taxpayers save for a pension. The current yield of 1.78% on 10 year bonds compares with the long term average yield of 6.1%. The current yield has been artificially doctored by the Bank of England (the Bank) by buying up £ 325 billion (plus another £ 50 billion in the pipeline) out of about £1trillion of U.K. government debt. The undershoot has occurred as a consequence of the Bank using an instrument –quantitative easing- which lowers long term yields on gilts- for short term purposes. In this case it was not that the financial markets got their pricing wrong, but government action by the Bank that brought down the yield. Managing the gap between the short and long term actions by savers requires market intervention by the Bank in the gilts markets. It is a contradiction in terms in using the long term gilts markets for supplying short term liquidity to the banking sector. Funding for lending programmes can do the same job without any interference in the gilts markets.

A quantitative easing programme puts an unequal –some might go as far as say unfair- competition element in the private savings markets. The Bank can create money at 0% interest rate costs. Banks need to reward their savers and so do pension funds. They need a positive yield over their costs of funds. Hence they cannot compete with the Bank.

What should be such yield? The long term average yield has been 6.1%. In the last three years, which coincided with the Bank's QE programme, the real return has turned strongly negative. In September 2009 the positive spread of yield over inflation was still 2.15%; from January to June 2010 this difference had dropped to 0.1%; in the second half of 2010 the yield difference became a negative 0.6%; for the first half of 2011 it went to a further negative 0.95%; in the second half of 2011 it went down to minus 2.2% and it stayed negative to the tune of minus 1.5% over the first five months of 2012.

There has been no period since 1990 that the 10 year yield on U.K. gilts was not a positive 2% or more over U.K. inflation rate in the same period, apart from the period since September 2009.

Managing financial risks is not done by creating inflation and is also not done by discouraging private sector savings. It is also not done by forcing companies to pay additional amounts into DB funds, which take money away for investment purposes. Managing financial risks is done through balanced budget policies.

The U.K. government needs private savings to fund its past debt and current deficit coverage. U.K. companies need those savings and so do the property markets. Banks need the positive income from gilts to manage their credit risks better. Creating stability in the long term U.K. government gilt market should be a normal part of the Bank's operations. The logical target is around 2% over the inflation level, the latter currently at 2.4%, so the ten year gilt yield should be around 4.4%. The U.K. economy is seen as a safe haven economy. In these circumstances to gradually jack up yields to 4.4% should not be difficult in any way, local and foreign savers will jump at the opportunity. Buying and selling operations can help stabilise the gilt markets, but under- or overshooting is detrimental to the overall economy and to any saver in the country. It is based on a misunderstanding of the nature of short and long term savers' actions.