Resolution Foundation

The Macroeconomic Policy Outlook

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UK Government borrowing costs have once again been in the headlines. Recent moves have, however, been overblown: since benchmark 10-year yields peaked at post-financial-crisis highs of 4.9 per cent in January, they have fallen back. 1And while it's true that 30-year yields have reached their highest level since 1998, such long horizons are less important to the Government, and changes reflect lower pension-fund demand. But the fact that UK borrowing costs were the highest among OECD rich countries in August is alarming. What makes this exceptionalism more puzzling is that, on the face of it, we are far from the worst fiscal offender. UK debt is solidly mid-table compared to other rich countries and there is at least a plan to bring borrowing down, unlike the US or France, even if that plan is taking longer than expected. So in this edition of the MPO we take a longer view, unpacking why the rise in UK yields since the pandemic has been larger here than elsewhere, and discussing how policy should respond.

Part of the explanation for higher UK borrowing costs comes from increases in expectations for Bank of England policy rates: surveys suggest this explains around two-thirds of the increase in 10-year yields since they started rising in 2021. In fact, such expectations are at a similar level to those for the US where inflation has proved sticky and concerns about tariffs linger. The risk premium demanded by investors to hold UK Government 10-year debt has risen by around 1.5 percentage points. The Bank of England's Quantitative Tightening (QT) sales are contributing to this. But, given our reliance on borrowing from abroad, the UK has also been vulnerable to a rising tide of concerns about government debt globally, and this can plausibly account for the rest.

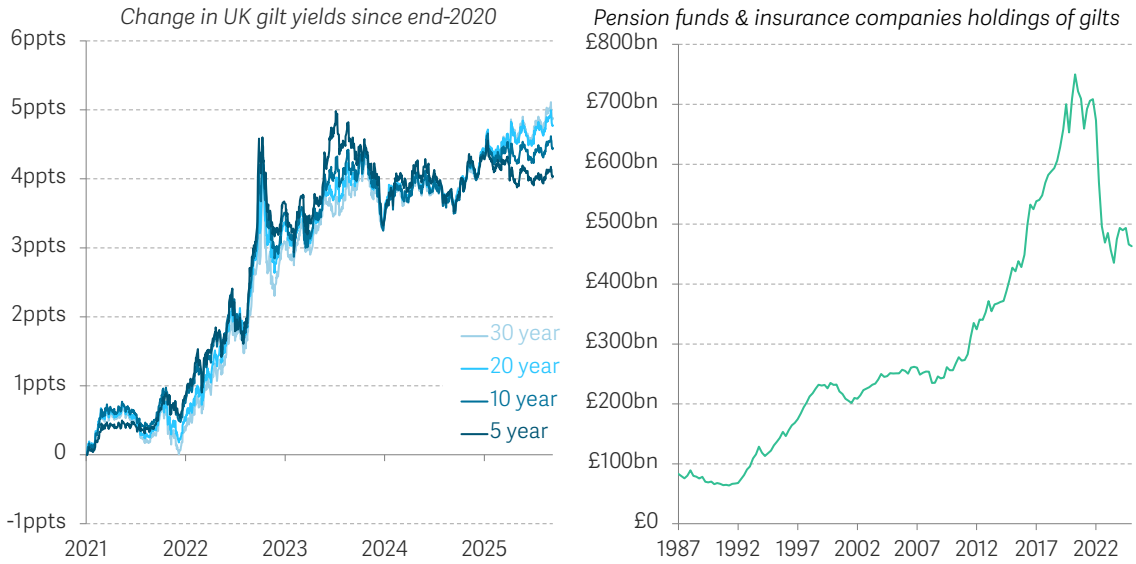
So UK 'exceptionalism' reflects a double whammy of US-style inflation concerns and a heightened exposure to global markets. To be clear, much of this is not directly related to concerns about the public finances. And talk of gilt-market dysfunction and IMF bailouts do not reflect the current reality. But there is a risk of more destabilising volatility. So the Chancellor should be clear that the Autumn Budget will be used to address any shortfall against its fiscal rules. There is a strong case for going further and increasing 'headroom' against these fiscal rules. The Bank of England should also slow its QT sales in line with achieving its 2 per cent inflation target. And the Debt Management Office should minimise issuance at longer horizons. More than anything, a 'head in sand' approach that pretends we can live without fiscal constraints ignores the risk of a forced policy tightening in the face of market volatility.

Alarmingly, UK Government debt servicing costs are the highest among OECD rich countries

UK borrowing costs have hit the headlines once again, putting more pressure on the Government and adding to the sense of pessimism surrounding the economic outlook. The 10-year benchmark yield approached its post-financial-crisis peak of 4.9 per cent (set in January) with larger, eye-catching changes at longer horizons: the 30-year gilt yield reaching its highest level since 1998, at 5.9 per cent. Despite the hype around these summer moves, the reality is the situation hasn't changed all that much: 5- and 10-year gilt yields have traded in a narrow range, and are down on their January peaks. Meanwhile, longer-dated gilts faring worse (Figure 1, left panel) is not surprising given changes to the market: prior to the pandemic, defined benefit (DB) pension funds were rapidly increasing their holdings of longer-dated gilts (Figure 1, right panel). This period has come to an end as pension funds respond to higher interest rates and DB funds mature.2 And, as Bank of England Governor Andrew Bailey pointed out at his recent Treasury Select Committee hearing, longer-dated gilt yields do not give a good read on the costs of servicing debt given the vast majority of issuance takes place at shorter horizons.

FIGURE 1: **Rising longer-dated borrowing costs likely reflect lower demand from pension funds**

Change in government bond yields relative to end-2020 level, percentage points (left panel) and pension funds & insurance companies' holdings of gilts (right panel): UK



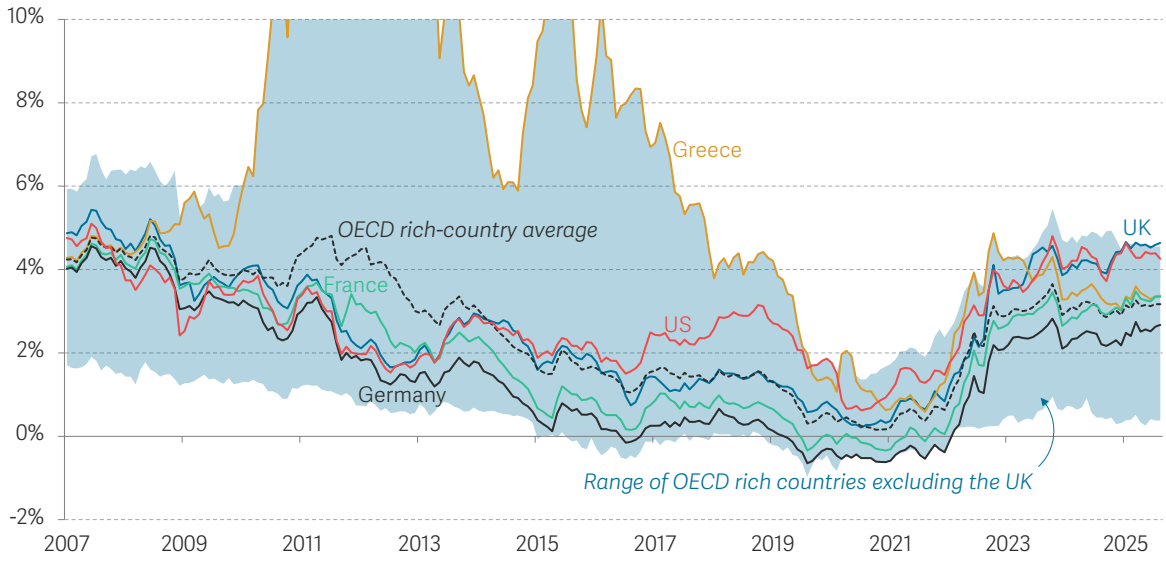
SOURCE: RF analysis of Bank of England, Yield curves and exchange rate data; and ONS, National Accounts.

More worryingly, however, in August benchmark 10-year yields were the highest among 24 long-standing rich countries for which the OECD collects data (Figure 2), a group

which includes countries hit hard during the euro-area crisis such as Greece.3 And while increases in yields since the Spring Statement have added around £4 billion to debt-servicing costs by 2029-30, the much bigger issue is why these costs have more than quadrupled since 2020-21, to £105 billion in 2024-25. So, in this edition of the MPO, we step back and look at what is driving this UK 'exceptionalism', and discuss how policy should respond.

FIGURE 2: **the UK has the highest borrowing costs among OECD rich countries**

10-year government bond yields: OECD rich countries



NOTES: For the purposes of this chart OECD rich countries comprises: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland and the US. SOURCE: OECD, Financial markets data.

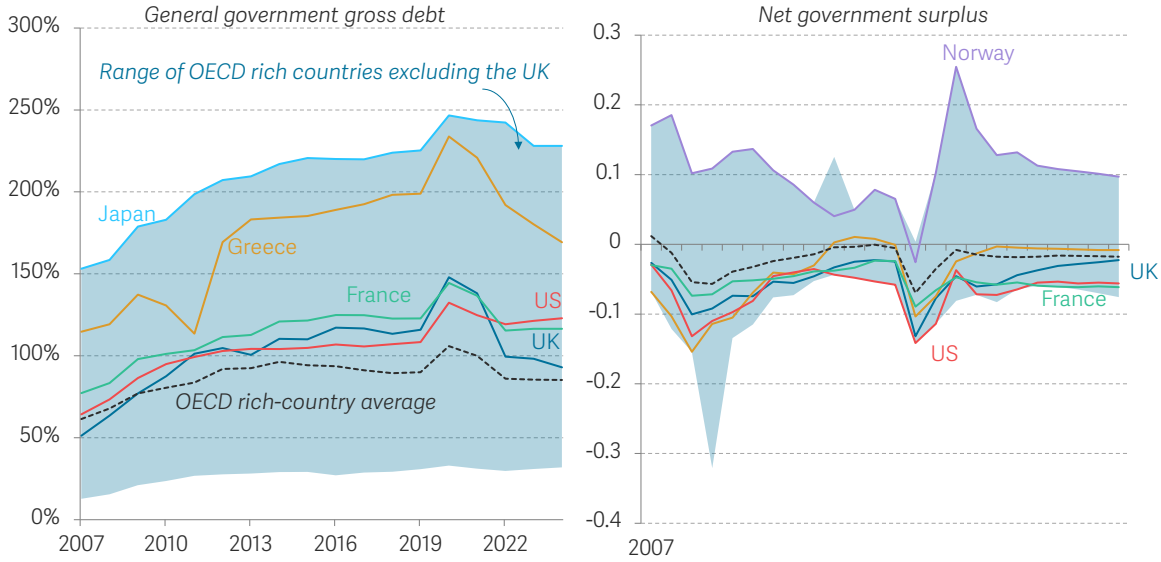
The obvious place to look for the answer is the public finances. To that end, Figure 3 puts the UK's debt and deficit position in context. As Chris Giles has pointed out, in this space the UK looks far from the worst offender. UK Government debt has nearly tripled since the early 2000s, but it remains solidly mid-table among OECD rich countries. And, although the deficit is still around 5 per cent of national income, there are five countries (out of 24) with larger deficits in the IMF database (Belgium, France, Israel, New Zealand and the US). Moreover, unlike the US and France, the UK Government has a plan to bring the deficit down. It's true that progress against this plan has been slower than hoped: the initial outturn data for the 2024-25 deficit is £149 billion, more than four times higher than forecast in March 2022! But it's hard to argue that the UK's borrowing-cost woes are wholly explicable based on fiscal fundamentals.

Part of the reason for UK 'exceptionalism' is related to higher expected policy rates...

To figure out what is driving UK borrowing costs, it's helpful to breakdown changes in yields into central bank policy rates and the premium over and above that required by investors to hold government debt.4 Figure 4 (left panel) shows survey estimates of policy rates averaged over the next 10 years for the UK, US and euro area. One point this analysis brings home is that we should not be at all surprised that rates have been rising: markets have been adjusting upwards their expectations for both near-term policy rates (as central banks fight the rise in inflation) and where those rates will settle in the longer term. This data suggests that expectations for the average Bank of England policy rate over the subsequent 10 years have risen by around 3 percentage points since end-2020, accounting for two-thirds of the roughly 4.5 percentage point rise in yields over the same period.

FIGURE 3: **Fiscal fundamentals do *not* suggest the UK is an outlier**

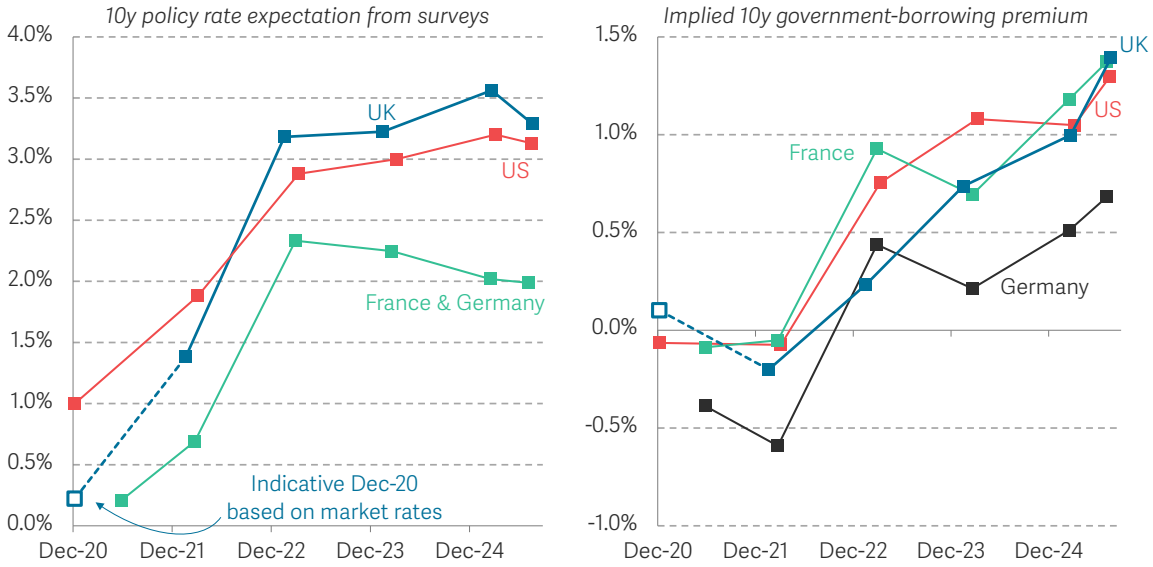
General government gross debt (left panel) and net borrowing (right panel), proportion of GDP: OECD rich countries



NOTES: All measures are for general government. Data for debt is outturn data from the OECD database; borrowing is from the IMF WEO database and includes forecasts. SOURCE: OECD, Public finance main indicators; and IMF, WEO database, April 2025.

FIGURE 4: **Both expected policy rates and risk premia are contributing to UK 'exceptionalism'**

10-year policy rate expectations from surveys (left panel) and implied 10-year premium on the cost of government borrowing: selected advanced countries

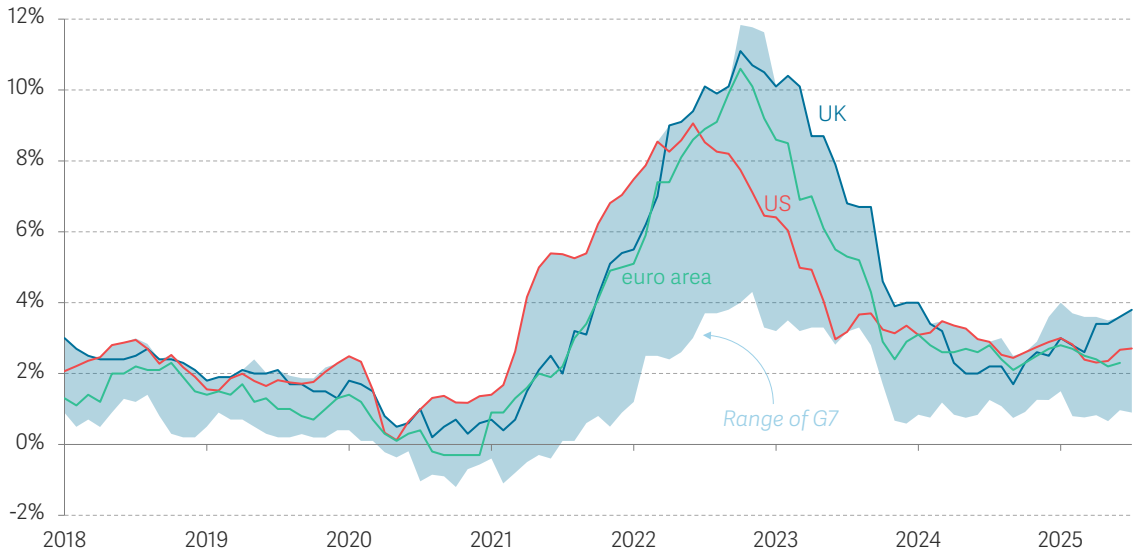


NOTES: 10-year rate expectations are the average of median survey expectations for the path of policy rates over the subsequent 10 years on survey dates. Government borrowing premium is backed out from the 10-year government bond yields on survey dates less the survey-based measure of expected rates over the next 10 years. SOURCE: RF analysis of Bank of England, Yield curves & Market Participants Survey results, various; Federal Reserve, Responses to the survey of market participants, various; European Central Bank, The ECB Survey of Monetary Analysts, various; Federal Reserve Bank of New York, zero-coupon Treasury yields; Deutsche Bundesbank, Term structure of interest rates on listed Federal securities; and Banque de France, Constant maturity rate, 10 years.

Higher expected policy rates also provide a significant part of the explanation for the UK's exceptionalism, particularly relative to European countries. Surveys suggest that the Bank of England's policy rate is expected to average around 3.25 per cent over the next 10 years. This is higher than the 10-year average for the US Federal Reserve (3.1 per cent) and the European Central Bank (2 per cent). So a key reason for the UK's higher borrowing costs is that the market thinks that policy interest rates here will be higher for longer. This could be because UK inflation has proved 'stickier' than elsewhere (Figure 5). Another potential factor driving expected policy rates higher is looser fiscal policy. At the Budget last year, the Chancellor announced the largest loosening in fiscal policy, outside of a major crisis, since the early 1990s. Treasury estimates suggest this could increase policy rates by as much as 0.6 percentage points, feeding through into higher gilt yields.

FIGURE 5: **UK inflation has proved 'stickier' than in other G7 countries**

Headline 12-month CPI inflation rate: US, euro area and UK and range for G7



SOURCE: ONS, Consumer Price Inflation; BLS, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average; Eurostat, Euro area (changing composition) - HICP - Overall index; and OECD, Consumer price indices (CPIs) - Complete database.

...but higher UK borrowing costs also reflects a rise in the gilt risk premium

But expectations of future Bank policy rates can't be the only explanation. As shown in the right panel of Figure 4, the rise in gilt yields has been around 1.5 percentage points larger than the rise in expected policy rates since end-2020. Put another way, if the survey-based measures of future policy rates are accurate, then the risk premium – the extra return required by investors to hold longer-dated gilts – has also increased.

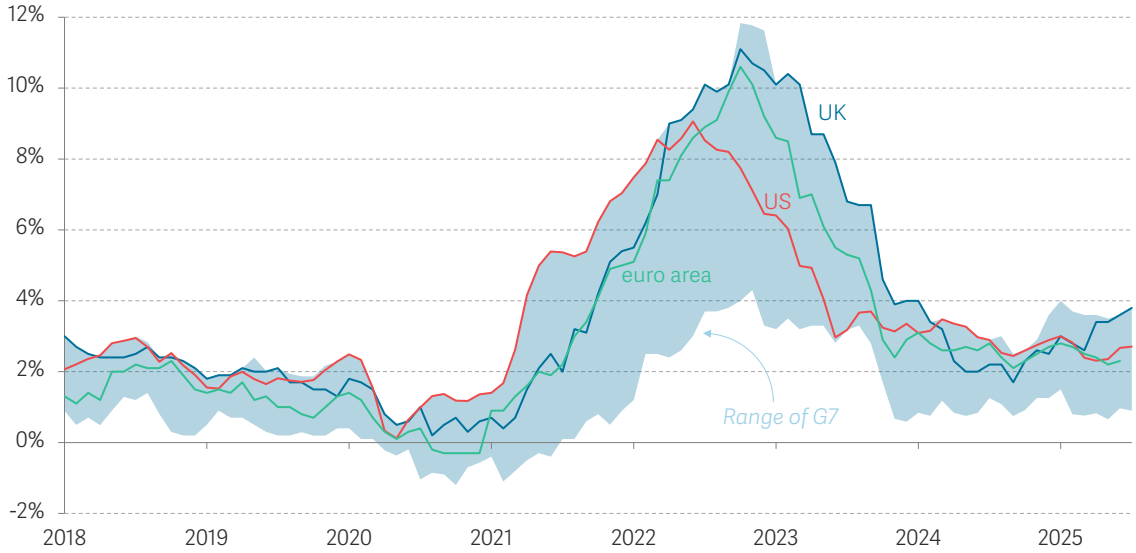
So what drives this premium? It will also be affected by gilt-market specific factors, most obviously changes in supply (including how much is held by the Bank of England) and demand, including how willing investors are to hold them.

On supply, the Bank of England's sales of gilts ('quantitative tightening', or QT) will tend to reduce the price of gilts, pushing up on yields. The Bank is unusual among central banks in actively selling assets bought during the financial crisis and pandemic, rather than reducing holdings passively as bonds mature. Sales began in October 2022, with an initial £80 billion of gilts and £20 billion of corporate bonds in the first year, followed by reductions in the size of the Bank's gilt holdings of around £100 billion a year since. The Bank's own estimates suggest that sales could be adding 0.15-0.25 percentage points to the premium on a 10-year gilt. This estimate is based in large part on changes in gilt yields around the time of announcements of sales. But this approach won't capture anticipation effects, or any that come through at the time of sales. One Bank of England study that focused on the effects at the time of sales found that the first round of QT alone may have increased yields by around 0.2 percentage points. So it is plausible that QT has had a larger effect than suggested by the Bank's own estimate. That would be consistent with international work on the impact of asset sales. To be clear, such an impact would still suggest that the impact of QT is a lot

smaller in magnitude than quantitative easing (QE), where initial Bank of England estimates suggested that the first £200 billion of QE reduced gilt yields by around 1 percentage point.

FIGURE 6: **UK yields generally move closely with global yields but at times gilt yields appear disproportionately affected by changes in global sentiment**

Rolling regression of sensitivity of UK 10-year yields to changes in US yields (180-day and 20-day averages)



Note: Sensitivity is 180-day moving average of simple OLS regression sensitivity estimated in first differences. Dots report selected 20-day average sensitivity estimates.
SOURCE: RF analysis of Bank of England, Yield curves; and Federal Reserve Bank of New York, zero-coupon Treasury yields.

As well as changes in gilt demand from domestic investors, such as pension funds, yields will be affected by international investors' demand for gilts. Because of our reliance on foreign investors (the 'kindness of strangers'), this is particularly important for the UK. In this context, recent international concerns about increases in public debt globally (Figure 3) have come with increases in gilt yields. Figure 6 illustrates what is going on. It shows a simple (regression) mapping from changes in US Treasury yields to changes in gilt yields. It shows that gilt yields move closely with those in the US: on average since 2016, a 1 percentage point increase in US Treasury yields has been associated with an increase of around 0.6 percentage points in UK gilt yields. But, at times – including around the mini-budget and immediately after Brexit – gilt yields have become more sensitive to changes in investor sentiment as proxied by changes in Treasury yields (the dots in Figure 6 show higher frequency co-movement around selected events). If we consider trading days since end-2020 on which gilt yields have moved in the same direction as those for the US, France and Germany, and have moved by more than average, gilt yields have risen by around 1.5 percentage points on those days. This is consistent with the idea that global concerns have disproportionately affected gilts. By contrast, yields fell on average on days when the UK moves were in the opposite direction to moves in those other countries' bonds, suggesting UK-specific concerns were less important.

Policy should be used to reduce the risk from further market volatility

Putting all this together, then, UK 'exceptionalism' reflects a double whammy of US-style inflation concerns and a heightened exposure to global markets – the combination of sticky inflation and reliance on foreign investors has left us paying more to service our debts. More worryingly, the high sensitivity of UK risk premia to changes in investor sentiment suggests there is a risk of further destabilising volatility in financial markets (as we warned in January).

So how can policy reduce this risk? Much of the policy response should come from the Chancellor and be focused on the need to demonstrate the UK's credible commitment to sustainable public finances and reducing fiscal risks. Instead, following policy 'U-turns' and pressure from within the Labour Party to increase borrowing, uncertainty has increased. The Government should be clear that it will use the Autumn Budget to decisively address any shortfall against its fiscal rules. At the Budget itself, there's a clear case for increasing the buffers – or 'headroom' – relative to the fiscal rules. And policy changes that significantly increase the Bank of England's inflation challenge in the near term should be avoided.

There is also a strong case for slowing QT sales. This is a decision for the Bank of England, and should be taken in the context of achieving the Bank of England's 2 per cent inflation target. But QT is contributing to tighter financial conditions (i.e. higher longer-term interest rates), even if the extent of that is uncertain. If that contributes to tighter fiscal policy, which is not currently factored into the Bank's forecast, there is risk that the inflation target will be missed. At the very least, then, the Bank should deliver the slowing in sales that is expected by the market (from £100 billion a year to £72 billion) at the September Monetary Policy Committee meeting.

Finally, the rise in longer-term yields suggests that the Debt Management Office (DMO) should minimise issuance at the long end. In the past, the DMO sensibly extended out the maturity of debt during periods in which rates were low and demand for longer-dated assets was high, but neither of these conditions apply now. Recent indications from the DMO suggest that it intends to use the flexibility within its remit to shorten maturities. The remit update at the Budget may provide an opportunity to go further.

More than anything, simply hoping that the problem goes away in time, or pretending that we can operate without any fiscal constraint ignores the risk of a forced policy tightening in the face of further volatility.

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1 Useful conversations with Ruth Curtice, Toby Nangle, Gregory Thwaites as well as colleagues at the Bank of England, the Debt Management Office and HM Treasury are gratefully acknowledged. Any errors or omissions remain those of the author.

2 There are measurement issues surrounding the data on insurance-company and pension-fund holdings of gilts with a range of estimates from survey and official data. For the purposes of this note, the key point is that the period in which pension funds have been rapidly acquiring longer-dated gilts has come to an end and is likely to go into reverse in the coming years. For a discussion of these issues, see: the most recent OBR, Fiscal Risks and Sustainability Report.

3 Throughout this note we focus on a group of advanced countries excluding former emerging European and Asian countries which we refer to as 'OECD rich countries'.

4 We use 'premium' here as a catch all for a number of factors that will affect the price of government debt. These include, the credit risk associated with borrowing from the government (usually thought to be close to zero), a 'term premium' reflecting the return to holding a longer-dated asset; and a convenience yield, from holding highly-liquid government debt.

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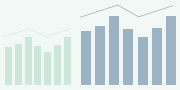

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