Institute for Public Policy Research

RULE OF THE MARKET

HOW TO LOWER UK BORROWING COSTS

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December 2025

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Citation
If you are using this document in your own writing, our preferred citation is:
Ellis W and Jung C (2025) *Rule of the market: How to lower UK borrowing costs*, IPPR. http://www.ippr.org/articles/rule-of-the-market

INTRODUCTION

The UK is paying a premium on its borrowing costs that 'economic fundamentals', such as the sustainability of its public finances, cannot fully explain. This constrains policy. To lower borrowing costs, the government must continue to rebuild credibility, carefully manage market sentiment and pursue growth-enhancing policies with high returns. The budget was a first step – it confirmed fiscal consolidation is coming, while protecting growth – but this process needs to continue.

WHAT HAS HAPPENED TO BOND YIELDS IN THE UK – AND WHY DO WE CARE?

Anyone keeping up with the twists and turns in the run-up to the UK's autumn budget may have noticed how often 'bond markets' have taken centre stage. While some argue that the government should ignore these markets and borrow more, the tradeoffs regarding high borrowing costs are real and cannot be easily dismissed.

Higher yields (interest rates on government debt) directly inflate the cost of servicing national debt, diverting billions to interest payments which could be spent on public services. Gilt yields also act as the benchmark for the real economy: when the government pays a premium, that cost transmits to households via higher mortgage rates and to businesses through relatively costlier investment capital. This creates a drag on growth.

Bond yields have increased globally over the past few years, as interest rates have risen to tackle higher inflation and fiscal deficits have expanded globally. Central banks have also started to sell the bonds that they purchased during crisis (quantitative tightening (QT)), contributing to the disruption (IMF 2025a).

But UK yields have increased by more than others since the election – and this 'UK premium' could cost the exchequer between £2 billion and £7 billion each year by 2029/30.[1] This should be taken seriously – in total, borrowing is currently six times more expensive than in 2019.

Some of this premium (but not all of it) can be explained by the Bank of England's QT policy and UK pension funds buying fewer bonds. More broadly, the IMF have endorsed the UK's prudent fiscal plans (IMF 2025b), and in the words of the FT's economics commentator Chris Giles (2025a) – the UK is "a fiscal saint, not a sinner".

The remainder of the premium therefore appears divorced from the UK's fiscal reality – it appears too high – reflecting uncertainty that plans will be delivered. The budget is the first step in signalling that the government is sticking to its plans. If credible, and delivered, the premium should reduce. The Bank of England stopping active bond sales could also play its part in bringing down borrowing costs.

1 Approximate calculation based on the change in spreads vs US (around +66bps max) and Euro area (around +20 bps min), since the general election – see figure 1. The maximum and minimum between both 30- and 10-year bonds are taken due to their importance for UK debt refinancing. Applying the OBR's debt interest ready reckoner (OBR 2025) to these figures gives roughly £2 billion to £7 billion by 2029/30. This increased cost only materialises when the UK refinances its debt.

A UK PREMIUM HAS EMERGED OVER THE LAST FEW YEARS – AND INCREASED SINCE THE GENERAL ELECTION

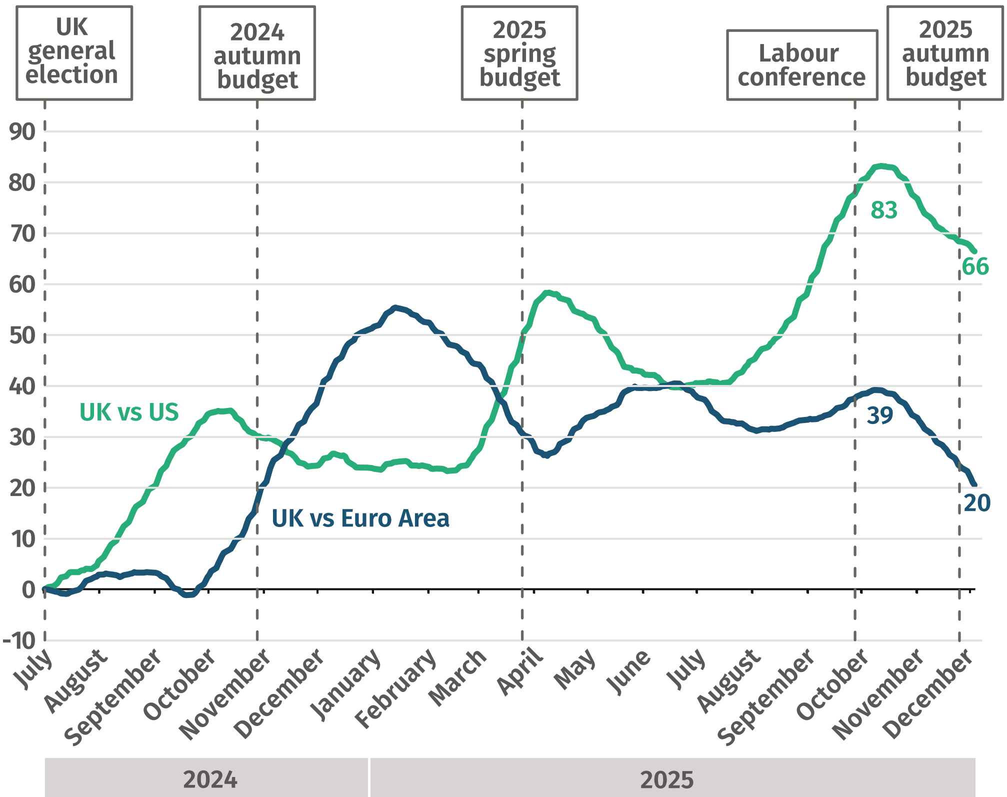
Only short-term (two-year) borrowing costs have increased by similar amounts to those of the US and the Euro Area since 2022 – but for longer-term debt, a gap starts to emerge. 10-year borrowing costs have increased by around 100 basis points more than the US, and 50 basis points more than the Euro Area. **This gap – or implied 'UK premium' - widens as the duration increases.** 30-year borrowing costs have increased 137 basis points more than the US, and 89 basis points more than the Eurozone (AAA rated).

This premium further increased after the UK general election – but there are signs of progress in the last couple of months.

FIGURE 1

Since the election, 10-year UK bond yields are up 66bps more than the US, and 20bps more than the Euro Area

Cumulative change in UK yields vs US and Euro Area AAA since UK general election, 30-day moving average, basis points



Source: BoE 2025a, FRED 2025a and ECB 2025

Note: This is the cumulative change in the spread of 10-year bond yields since the UK general election, vs US and Euro Area AAA debt. A 30-day moving average is taken to assess broad trends – so reactions may not fall precisely on events highlighted. Political events are noted for narrative assistance, but this does not mean that these events are the only drive of the spread – the author appreciates that spreads react to a multitude of domestic and international factors. Publicly published par yields are used for the US for timeliness. Zero coupon data - not published here - shows very similar results.

Figure 1 shows this premium since the election by looking at the 'spread' (difference) between 10-year UK gilts and bond yields in the US and Euro Area. These spreads have been increasing consistently the UK election, with yields ending up 66bps higher than in the US and 20bps more than in the Euro Area (AAA). The picture is very similar for longer-dated bonds, so these are excluded for brevity.

However, **the government's strong recommitment to its fiscal plans does appear to be reducing costs more recently**. This starts with the chancellor's speech at Labour conference, where she recommitted to the fiscal rules, with the premium down by around 20bps since then. There also look to be tentative signs of further progress since the November budget.[2] This is in line with reports from financial markets, emphasising that certainty about the government's fiscal plans is key. There are many external factors that can influence this spread, beyond the UK government – but the consistency of the increase versus US and the Euro Area since the election, and decrease since the conference, is striking.

This matters, since borrowing costs constrain government borrowing. The UK currently spends £92 billion on interest payments this year – about 7.5 per cent of government receipts. **Reducing the UK premia in figure 1 to zero could save the chancellor roughly £2 billion to £7 billion each year by 2029/30.**[3]

We are in a new era where additional borrowing costs six times more than it did before the pandemic. This makes sticking to current fiscal plans essential; bringing down the UK premium is rightly a key priority for the chancellor.

There are still some circumstances where more borrowing compared to current plans could be sensible – in an economic crisis for example. Similarly, the government could borrow to invest if it could show that this funds projects with high economic returns. But if bond markets are not convinced that this will deliver high returns, and thus high growth, higher interest rates will increase the cost of these policies and significantly limit the economic benefits.

WHY MIGHT BORROWING COSTS INCREASE?

The first suspect is inflation. Intuitively, investors should demand higher interest payments today if they expect prices to be growing faster tomorrow. UK households *do* report higher expected inflation than before the election, and inflation in the UK has been slower to reduce than in other countries.

But when it comes to pricing gilts, the views that matter most are those of market participants actually buying and selling them. Here the story looks very different.

Market-based measures of inflation expectations – such as 'breakeven inflation', derived from the gap between conventional and index-linked gilts – have been broadly flat or slightly *falling* across most maturities. While investors price in some risk that inflation is above target/forecast, these expectations have generally not

2 The spread is down by 10bps and 7bps compared to the US and Euro Area, respectively, since the autumn budget.

3 Approximate calculation based on the change in spreads vs US (around +66bps max) and Euro area (around +20 bps min), since the general election – see figure 1. The maximum and minimum between both 30- and 10-year bonds are taken due to their importance for UK debt refinancing. Applying the OBR's debt interest ready reckoner (OBR 2025) to these figures gives roughly £2 billion to £7 billion by 2029/30. This increased cost only materialises when the UK refinances its debt.

increased since the election (see appendix). The short-lived increase in 2025, in other words, did not increase the longer-term expectations of investors of where inflation will go.

Nor are markets suddenly expecting a much higher bank rate. Since the UK general election, bond market analysis shows that the expected path of interest rates has declined across the curve (LJKmfa 2025a).[4] Investors see lower rates from the Bank of England since the general election, not higher.

If investors aren't demanding relatively higher returns in the UK because they fear inflation or higher base rates, they are demanding them because they perceive a higher risk in holding UK assets specifically. This is a classic 'term premium' – an extra return demanded for the uncertainty of what the macroeconomic environment will be.

THE UK LOOKS TO BE STUCK IN A NEGATIVE VIBES EQUILIBRIUM

The gilt market is a coming together of buyers and sellers like any market. Analysis of recent changes in the UK gilt market needs to consider this backdrop of buyers and sellers, and here there are two recent shifts.

First, the exit of UK defined benefit pension schemes. These pension schemes historically accounted around 28 per cent of the total gilt market (with even more concentrated at long durations) (FRBC 2025), as funds were willing to purchase UK debt "at sometimes eye-watering prices" (Simpson and Linz 2025) to match safely their long-term liabilities. Defined benefit pensions were always expected to withdraw in the long-run as the schemes became less popular, but this exit was accelerated by the 2022 'LDI crisis' where pension funds were caught off guard by rising interest rates following the Liz Truss mini-budget and made significant losses. This required them to behave more cautiously, ultimately reducing pension fund demand for gilts.[5]

Second, the Bank of England has been selling government bonds as part of its QT programme. The bank held around 35 per cent of the gilt market at peak in early 2022 (BIS 2024), dropping to just 20 per cent today and with further cuts scheduled.[6] The Bank of England is the largest owner of gilts, and it has been selling them at record pace – very much at odds with what other central banks have been doing. This will have contributed to pressures on yields, up to 0.25 percentage points.[7]

International investors have, to some extent, filled the gap in demand left by the Bank of England and defined benefit pension schemes, but at the expense of making the UK gilt market more exposed to changing global sentiment.

4 This indicates that policy rate expectations at the two-, five-, 10- and 30-year horizons have declined since the UK general election. Krippner's published materials are based on OIS and government bond curve decompositions. See LJKmfa (2022, 2025) for overviews of the models used for the decompositions.

5 Following the shock, regulators mandated significantly larger liquidity buffers (around 300–400 basis points) to withstand volatility. This effectively forced schemes to hoard cash rather than leveraging up to buy bonds, while a surge in insurance 'buy-outs' has further transferred assets to insurers with different investment priorities. See Toby Nangle's evidence in WPC (2023).

6 The Bank of England held around £500 million in UK gilts (BoE no date), with £2,767.26 billion total nominal value of the gilt market (DMO 2025).

7 Bank of England analysis suggests up 25 basis point impact of QT on 10-year yields, without accounting for the relative impact of QT in the UK versus peers (BoE 2025b). The bank has also since slowed its QT programme (Stewart 2025). The European Central Bank (ECB) and Federal Reserve (FED) both have similar QT programmes.

Other explanations are given for high borrowing costs in the UK, but together with the above they cannot fully explain the increase in the UK. A higher liquidity premium on UK bonds[8] and more volatile or uncertain inflation[9] may be leading to some extra compensation. These factors are hard to assess, but there's limited evidence that these factors have amplified since the general election compared to peers.

Chris Giles (2025a) has also pointed out accurately that the UK is a fiscal saint, not a sinner. Our debt-to-GDP ratio sits at 101 per cent. While high by historical standards, it is significantly lower than the G7 average of 124 per cent, and well below the US (122 per cent), Italy (135 per cent), and Japan (237 per cent).[10] Borrowing will halve over the course of this parliament, falling in every single year. This makes the UK's coming fiscal consolidation the fastest in the G7 – reducing its deficit faster than the others, and to the third lowest level in the G7 in 2028 (Giles 2025b).

The International Monetary Fund (IMF) – the world's macroeconomic watchdog – recently gave the UK's fiscal policy its blessing, saying the UK's "fiscal plans strike a good balance between supporting growth and safeguarding fiscal sustainability" (IMF 2025d).

Yet a recent survey of economists had around two-thirds citing "fiscal sustainability concerns" as the main reason for elevated UK yields (NIESR 2025). That gap between the data and perceptions suggests something more subtle is going on: a *credibility problem* rather than a pure fundamentals problem. In other words, the UK's fiscal policy is solid, but markets are unsure whether it will be delivered.

The Truss mini budget in 2022 showed how quickly a UK government could bypass the fiscal framework, ignore the Office for Budget Responsibility, and announce large unfunded tax cuts. In the years leading up to it, successive chancellors had repeatedly changed, missed or redefined their own fiscal rules (IfG 2024). This is amplified by political instability, with the UK featuring seven different chancellors from 2016 up to the 2024 election. Previously, a chancellor may have claimed absolute faith in their fiscal rules – but experience has taught that these rules often change, not least because a new chancellor might be in post by the time the rules bite. Lack of trust in stated fiscal policy has set in, as actions have spoken louder than words.

This shows that the UK credibly sticking to its plans could go a long way in reducing the fiscal premium.

The IMF's former chief economist, Olivier Blanchard, has argued that bond markets can settle in different 'equilibria' – two countries with similar debt dynamics can have different borrowing costs simply because investors feel differently about them (Blanchard 2019). That's a useful way to think about the current UK position. We appear to be stuck in a high-borrowing-cost equilibrium, where negative sentiment and memories of past missteps keep gilt yields elevated – even though, on paper, the UK looks no riskier than many of its peers.

8 Liquidity premium is sometimes assessed by examining the gilt-swap rate, (z spread) since swaps are assumed to be risk free. On a 30-year basis this premium has increased since 2022, but is again broadly flat since the election (See Phillips 2025).

9 Proxied by the size of error bands in Bank of England forecasts- which have increased slightly since 2022, but remained constant since the election. Author calculations on inflation volatility, measured using 12-month standard deviation on the monthly rate of inflation, show broadly flat levels of volatility (see FRED (2025b) for harmonised monthly CPI measures for G7 economies).

10 Data cited is for 2024 as the latest full year of output, but the comparison is similar for 2025.

SMART DECISIONS COULD HELP THE UK ESCAPE THIS NEGATIVE EQUILIBRIUM

The flip side of a sentiment-driven premium is that it can be reversed. If the premium is based on a lack of confidence rather than a lack of solvency, credibility can improve quickly via a series of ‘good news’ events.

First, the government should continue to reassure markets that it will deliver on its overall fiscal plans. The recent budget was a great start – it more than doubled financial headroom and re-confirmed fiscal consolidation. In response, the UK premium against the Eurozone has almost halved. But well-publicised difficulties in communication represent a missed opportunity to allay any lingering sense of uncertainty. **From now on, clear and consistent messaging** (and ensuring political buy-in) **should help to eliminate any lingering uncertainty and further reduce the UK premium.**

Second, the government should minimise any risk not directly related to sentiment. The Debt Management Office should continue to shift issuance towards medium-term debt – reducing reliance on expensive 30-year maturities that no longer benefit from strong pension fund demand.

Third, the Bank of England has already slowed the pace of quantitative easing, but a full pause in sales (as in the US and the Eurozone) could reduce the UK premium.

The UK government could also consider rebuilding a domestic buyer base for UK debt. This is challenging, but regulatory incentives – such as targeted tax advantages or capital relief – could encourage insurers and pension funds to hold gilts again. Additionally, an expanded retail gilt programme could help diversify the investor base.[11]

11 As a novel example, the US has recently enacted legislation that requires stablecoin to be 100 per cent backed by US treasuries – which could strengthen the demand for US debt and lower yields (White House 2025).

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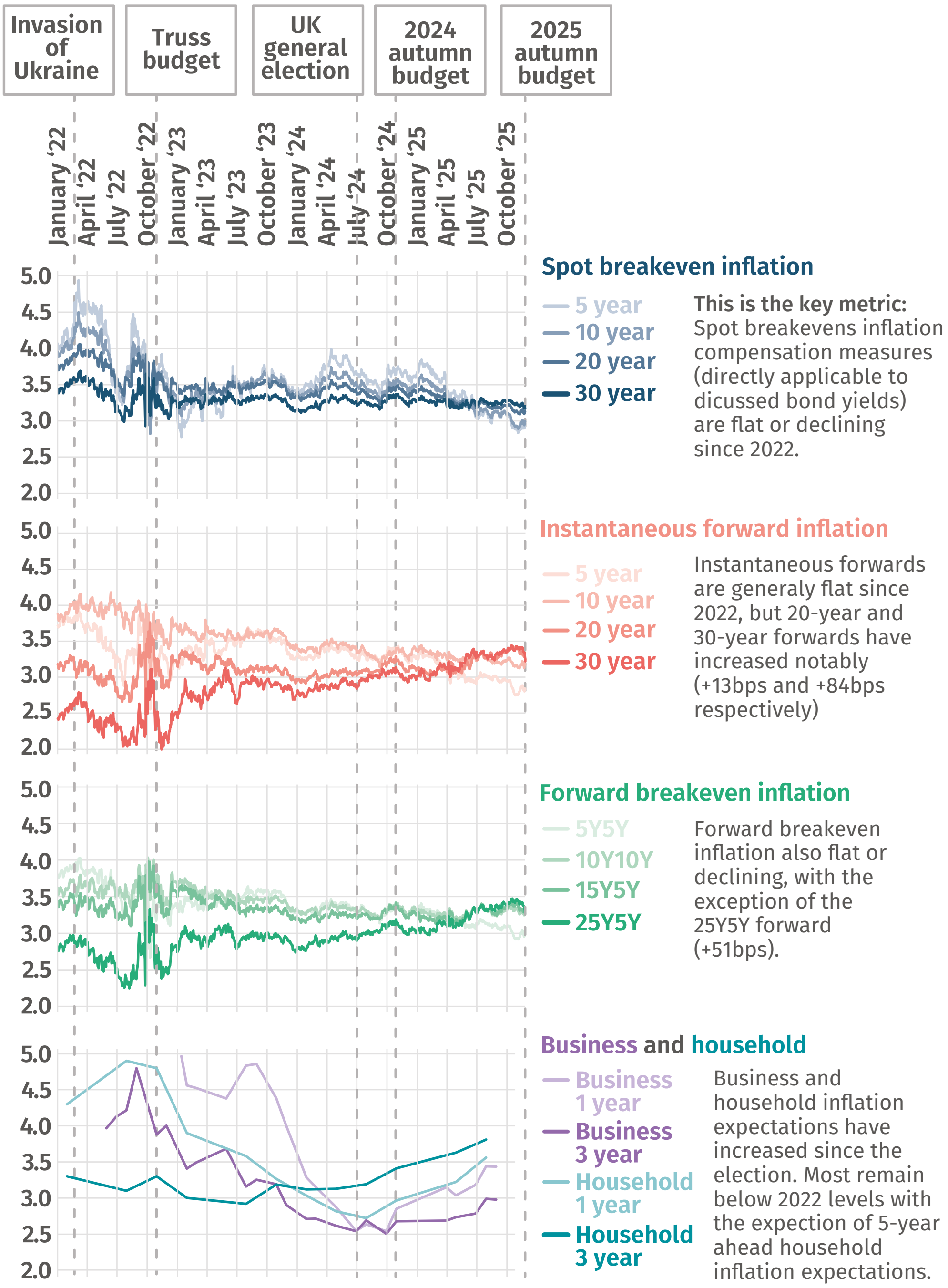
APPENDIX: MEASURES OF INFLATION AND INTEREST RATE EXPECTATIONS

FIGURE A1

Summary of inflation expectations since 2022 – market and household



Source: BoE 2025a, 2025c, 2025d

- **Spot breakeven inflation** (BoE gilt curve data): Market-implied average inflation over the life of each maturity from nominal vs index-linked gilts; since 2022 this has been broadly flat to slightly lower across most maturities, indicating little change in the average inflation priced into gilts (BoE 2025a – inflation compensation).
- **Instantaneous forward inflation** (BoE gilt curve data): Market-implied point-in-time inflation at specific future maturities (eg, the instantaneous 30-year forward); generally stable since 2022 but more sensitive at the long end, where 20-year and especially 30-year forwards have drifted up – picking up tail risks more than spot measures (BoE 2025a – instantaneous forwards).
- **Forward breakeven inflation** (BoE gilt curve data – user-derived): Horizon-specific average inflation between two dates (eg, 25Y5Y = years 25–30), constructed from the spot curve; mostly flat since 2022 with a modest rise in very long-run forwards (eg, 25Y5Y), consistent with some upward pressure at the far end but not a broad repricing (BoE 2025a – user-derived forwards from BoE spot data).
- **Business and household expectations** (surveys): Survey-based views rather than traded prices; both have ticked up recently but remain below 2022 peaks, with households typically higher/more volatile than businesses (BoE 2025c, 2025d).

What's going on: Taken together, market-based expectations remain largely stable on average over the next 30 years, but there are signs of long-term stress at the tail end (rising very-long-maturity forwards). That pattern points more to a higher long-end risk/term premium than to a broad rise in expected inflation.

ABOUT IPPR

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