

## How Britain found itself in a debt cage

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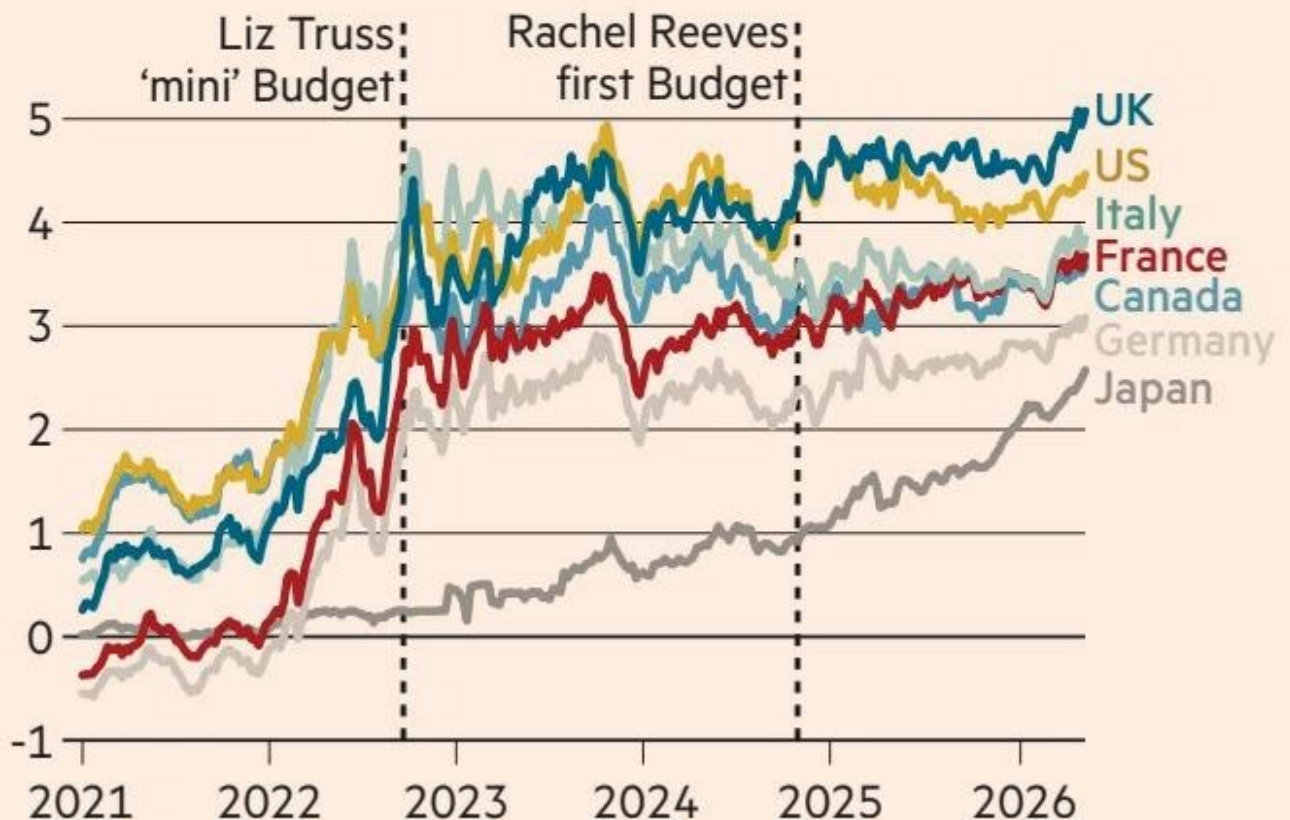
As politicians fight over the Labour leadership and the keys to No 10 Downing Street, a restive gilt market sets the limits of power and is ready to punish any deviation from fiscal discipline.

Hours before Britain's government was rocked by resignation yesterday, Chancellor Rachel Reeves stepped in front of the Downing Street cameras to warn that a Labour leadership battle risked "plunging the country into chaos".

Investors saw her comments not just as a reprimand to prime ministerial aspirants such as Wes Streeting, who quit as health secretary in the course of the day, but as the UK government's latest attempt to use the threat of a bond sell-off to stave off internal rebellion.

### The UK's gilt market may have become untethered from its peers

Yields on 10-year government bonds (%)



Source: LSEG

Such admonitions reflect a harsh reality facing all British politicians: whoever runs the government will be in thrall to a bond market that holds growing sway over debt-laden major economies. “This would be the first party leadership contest where the bond market has a vote,” said one Labour official.

It is a constraint that has bound the UK for years but one growing tighter almost every day that Sir Keir Starmer’s role as prime minister — and the future course of the country’s politics — is up for grabs. The restive market for UK government bonds, or gilts, is ready to punish any deviation from fiscal discipline.

“If you have an already structurally weak economy, and then throw political instability and populist policies on top, then you risk starting a debt doom loop,” says Mike Riddell, fund manager at Fidelity International. In such circumstances, markets push up borrowing costs, which in turn slow growth and increase the need for debt still further.

In the UK, gilts, once deemed one of the safest harbours for investor capital, have become unnervingly volatile, driving up what are already the highest borrowing costs in the G7.

This week, as leadership intrigues deepened and investors grew worried about Labour shifting to the left, the 10-year benchmark hit a post-financial crisis peak of more than 5.1 per cent.

With political uncertainty exacerbating a bond sell-off driven by worries about inflation and the Iran war, the yield on 30-year debt, which moves inversely to price, reached its highest since 1998.

Although the market then steadied, speculation over Labour’s leadership rose after it closed yesterday, when Makerfield MP Josh Simons said he was quitting his seat to pave the way for Greater Manchester mayor Andy Burnham to return to parliament — and potentially become prime minister.

The scope for governments’ tax and spending decisions has narrowed as the power of the bond market has grown, hitting both Conservative and Labour administrations’ ability to deliver on their promises and stoking antiestablishment politics.

Today, the Labour government is hemmed in by the markets’ gyrations, but investors could yet limit the ambitions of the UK’s insurgent populist parties.

The fiscal challenges facing the UK — an ageing population, diminished potential growth, rising welfare spending and surging demands for defence and other spending — also afflict other advanced economies.

But gilt investors worry the market has become untethered from its peers, with an increasing reputation for political dysfunctionality resulting in higher borrowing costs that hit households and businesses.

“The UK gilt market has been the least anchored of any major government bond market for four years now,” says Seb Barker, chief market strategist at hedge fund firm Marshall Wace, in a reference to the sequence of events that began with Liz Truss’s abandoned “mini” Budget of 2022.

On that occasion, a bond market revolt over billions of pounds in unfunded tax cuts pushed the then prime minister from office within days and led to fiscal retrenchment. Starmer’s frequent warning to Labour MPs in the past few days has been: “Do we want to be like the Tories?”

While most investors would not view the UK as on the precipice of a debt crisis, they say that the market has moved into a damaging new phase.

The burden is already squeezing out other areas of government spending: the UK spends more than £100bn a year on debt interest, which accounts for more spending than any public service other than the NHS. The bill is expected to reach nearly 4 per cent of GDP by 2030-31, according to official forecasts, around double what it was in the years running up to the Covid pandemic.

Centrist politicians are trapped between managing this debt inheritance and answering the growing pressure from populists to the left and right to spend more. Investors respond by demanding a greater premium against a shift towards policies that will push up borrowing or inflation further, and the rise in yields makes the public finances picture yet worse.

“It is one thing to be able to control the economics of a situation, but it is increasingly questionable whether we can manage the politics involved,” says Peter Kinsella of Swiss private bank UBP.

### **Addicted to debt**

At the turn of the century, Britain’s public debt pile was less than 30 per cent of its GDP. But when the financial crisis exploded, debt and deficit surged. Further shocks came this decade, including the Covid pandemic and the full-scale invasion of Ukraine.

The trend for 25 years has been one of debt “ratcheting ever upward”, according to an assessment last year by the Office for Budget Responsibility, the fiscal watchdog.

General government net debt, as recorded by the IMF, is set to peak in the UK in 2028 at nearly 96 per cent of GDP, well above the advanced economy average of 83 per cent, although below levels in the US, Japan, Italy and France.

The UK is more exposed than some if not all of those peers. Unlike the US, it does not issue the world’s reserve currency.

And while traders have lumped Britain together with Italy and France as the “BIFs” — bond markets’ latest problem children — the Eurozone countries benefit from lower rates and the backing of the European Central Bank, which has demonstrated its commitment to holding together the euro area.

Lower inflation in the bloc also means Italian and French 10-year yields are more than one percentage point below the UK's.

The added problem for London is that the combination of the UK's high public debt, weak medium-term growth prospects and surging debt interest costs has made it steadily harder to get public debt back on to a sustained downward path.

The OBR estimates that the primary surplus — which strips out interest payments — would need to be 1.3 per cent of GDP to stabilise debt, one of the highest levels it has ever forecast.

Reeves promised in the 2024 election to keep a tight rein on the public finances. But in her first Budget she boosted borrowing by £32bn a year, one of the biggest fiscal loosening for decades. Now the Iran war presents a further threat to the public finances. The Resolution Foundation think-tank estimates, based on Bank of England figures, that borrowing will be £16bn higher in 2029-30 than was expected as recently as the March OBR forecast.

“This is a precarious moment for the UK,” said Mahmood Pradhan, a former IMF official now at the Bruegel thinktank.

“Gilt yields have risen more than in many other countries around the world and this is down to political risk, not just the war. If a new prime minister wanted to expand public borrowing they would face a very quick adverse response from the gilt market.”

Even before the war and the Labour leadership turmoil, the UK was already heading into a harsh budget round in the autumn, warns Helen Miller, head of the Institute for Fiscal Studies.

Pressures from rising disability benefit spending and demands for more defence expenditure have made already tight spending limits on other departments even more punishing.

On top of this comes the country's mounting reputation for political instability, as government after government struggles with budgetary constraints and disappointed expectations.

The average tenure for prime ministers elected during the 2020s is under 500 days, far below previous decades. This has knock-on effects for investor confidence and appetite for the country's debt.

“There is an impression that the UK can't hang on to a leader,” says Miller. “Reputations are hard to build and quick to lose.”

### **The cost of money has gone up**

While past governments could take out debt at ultra-low rates, particularly in the aftermath of the financial crisis, today's politicians face a frightening cost of borrowing.

Pension funds — the traditional longterm buyers of sovereign debt — have retreated from the market. The fall in demand has helped push bond prices down and yields up. Market participants worry that the gilt market has been left more vulnerable to the whims of international investors and flighty hedge funds.

Gilts have also been hit by the UK's problems with inflation, which was running at 3 per cent before the Iran war, compared to 1.9 per cent in the euro area. As inflation expectations surged in line with oil prices after the war began, gilt yields have gone still higher as traders switched from betting on BoE rate cuts to rate increases.

Yet investors warn UK borrowing costs are also suffering from a risk premium — dubbed a “moron premium” since the 2022 “mini” Budget fiasco — an additional yield to reflect investor worries over the country's economic policies.

There is little sign of an impending meltdown of anything like the same scale as 2022, say investors. But there is a “lingering institutional trauma” from that crisis, says Reto Cueni, chief economist at Syz Group. “Political headlines are therefore feeding directly into funding costs far more rapidly than in previous cycles,” he adds.

Labour's record in office has also worried investors, from its first heavyborrowing Budget to U-turns on planned spending cuts. Bond giant Pimco warned last year that in the eyes of investors the UK was being treated as “guilty until proven innocent”.

Under her fiscal rules, Reeves has promised debt will fall as a share of GDP by the scheduled end of the current parliament in 2029. If IMF forecasts from April are borne out, the UK will by that time have the lowest budget deficit in the G7, at 2 per cent of GDP, alongside Canada.

But the country has a record of failing to deliver on pledges to curb borrowing and bear down on public debt, as attempts to bring discipline to public spending go askew in the lead-up to general elections.

Gilts rallied through the turn of the year, as hopes rose for interest rate cuts and Reeves increased her fiscal room for manoeuvre from near zero to more than £22bn. But the rally is now history as inflation and political concerns have reared up again.

Investors are now poring over potential leadership contenders' comments. Burnham was criticised last year when he said the UK should not be “in hock” to the bond markets; now he is suggesting defence spending can be increased outside the fiscal rules.

“The fear is that a new prime minister would have a looser hand when it comes to fiscal policy,” analysts at ING said in a note this week. They added that such a stance would make it still harder for the BoE to cut interest rates while increasing government debt.

Gilt investors, stunned that the Labour Party seems to be launching itself into an unpredictable leadership race in the middle of an inflation shock, are watching through their fingers as politicians predict they can face down gilt market movements. “If the British government is going to be completely dominated by the bond market, MPs might as well go home,” Diane Abbott, a veteran backbencher, said this week.

Investors' certainty that the market can keep Labour in line — a self-appointed policing role that has led some to describe them as bond vigilantes — could end up fuelling a challenge from populist insurgents on the left in the form of the Green Party and Reform UK on the right.

Bondholders are increasingly looking towards the next election and what having either Nigel Farage or Zack Polanski within a future coalition would do to the economic policies of the major parties.

### **Is there any way out?**

For politicians seeking to reduce Britain's dependence on the bond market, economic growth is the most attractive option.

But despite strong first-quarter GDP figures this week, some investors are not optimistic about longer-term prospects.

Fidelity International's Riddell says boosting productivity, "which the UK has failed to do ever since 2008, becomes increasingly difficult with an ageing and indebted population".

After Labour's failure to push through spending cuts in areas such as welfare payments, some analysts think tax rises could offer a more likely path to greater stability — and even spark a virtuous cycle of improved confidence and lower yields.

Indeed, when Reeves dropped a planned income tax rise ahead of the November Budget, she was punished with one of the worst one-day gilt selloffs in months, with 10-year yields jumping 0.14 percentage points.

The best case may be that the UK continues to muddle through, in the hope that the bond sell-off from the Iran war can reverse, and the current administration's attempts to bear down on borrowing can survive the political turbulence. But many see a lasting impact.

Robert Dishner, senior portfolio manager at Neuberger Berman, says the UK's growth struggles and faltering fiscal policies mean markets have a "delicate balancing act". He says it all reminds him of another European country once renowned for its own debt problems and near-permanent political crises: Italy.