

Macro Comment UK

Are financial markets fully pricing in fiscal sustainability risks?

The UK appears to be on an unsustainable fiscal trajectory. Most other G7 countries are in similar predicaments, but financial markets have continued to fund the perennial public deficits, implicitly assuming that policymakers will eventually implement changes that improve public finances. However, recent increases in government bond market term premia across the G7 would suggest that investors are becoming nervous. We argue that the evolving UK political context will now make it challenging for the government to implement reforms to alter the UK's long-term fiscal sustainability, which points to the higher UK term premia being sustained or potentially increasing further.

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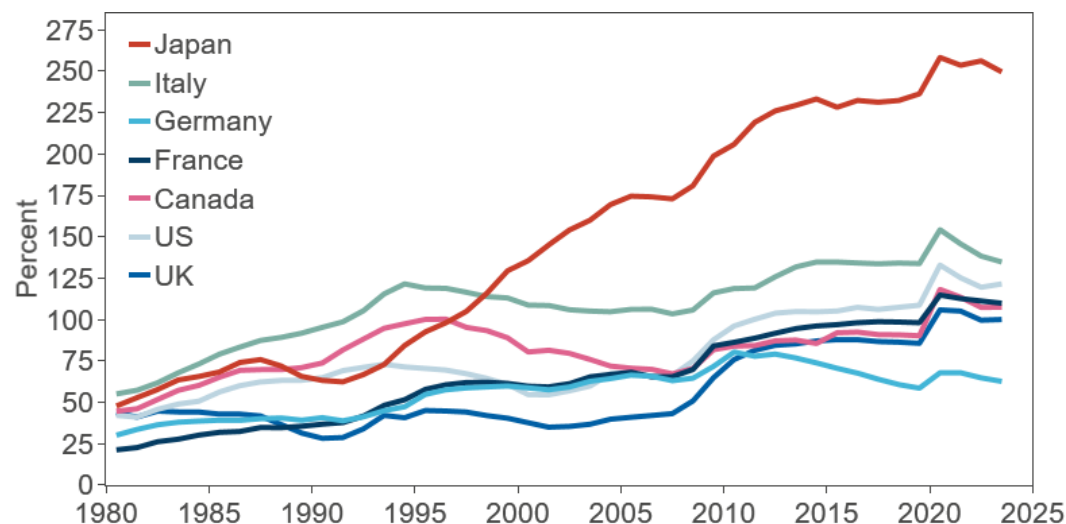
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Should policymakers worry about sovereign debt sustainability?

Sovereign debt is deemed to be “unsustainable” if it cannot be repaid without altering the contractual terms of the debt, or if the debt is rendered irrelevant via default, restructuring or inflationary policies^[1]. Olivier Blanchard, former director of the IMF's Research Department, argues that sovereign debt becomes “unsafe” when there is a non-negligible risk that existing and likely future policies spell an unsustainable trajectory for debt^[2]. According to this definition, it would seem logical to argue that both existing debt stocks held by most G7 countries and the impact of existing policies for the future pathway of debt trajectories could contribute to sovereign debt being in “unsafe” territory.

Sovereign debt may be on an “unsafe” trajectory

Figure 1: G7 debt to GDP levels



Sources: Macrobond and IMF

Current debt levels

There is evidence within academic literature that GDP growth rates can be hampered once sovereign debt levels become overly onerous. The exact point that this occurs is, naturally, a source of contention, but there is evidence to suggest that the UK – and many other G7 economies – are already at this point. For example, Reinhart and Rogoff argued that the level was at 90% debt to GDP^[3]. While this study was subsequently challenged, a study subsequently published by the World Bank found the threshold to be at just 77% for developed economies^[4].

Once debt-to-GDP levels become overly onerous, they can inhibit growth rates and hurt future governments' abilities to ensure that debt remains sustainable

Following notable jumps in debt-to-GDP ratios due to the Global Financial Crisis and, more recently, the pandemic crisis, it is clear that the UK's debt level of around 100% of GDP (depending on which measure you use) is above these thresholds. This suggests that current sovereign debt may be acting to inhibit growth rates and, in turn, hurting future governments' abilities to ensure debt remains sustainable. One transmission mechanism for the growth-suppressing effect of onerous debt levels is sovereign debt crowding out private sector capital formation due to the anticipation of worsening returns, as governments will be forced into tax increases and spending cuts to pay for higher debt interest payments. In addition, there are of course a number of other factors that have affected growth in the UK economy: these include, but are not limited to, lagging overall investment and productivity growth compared to G7 counterparts, disruption caused by the UK's exit from the EU, and recent structural issues in the labour market (for example, the growth in inactivity following the pandemic).

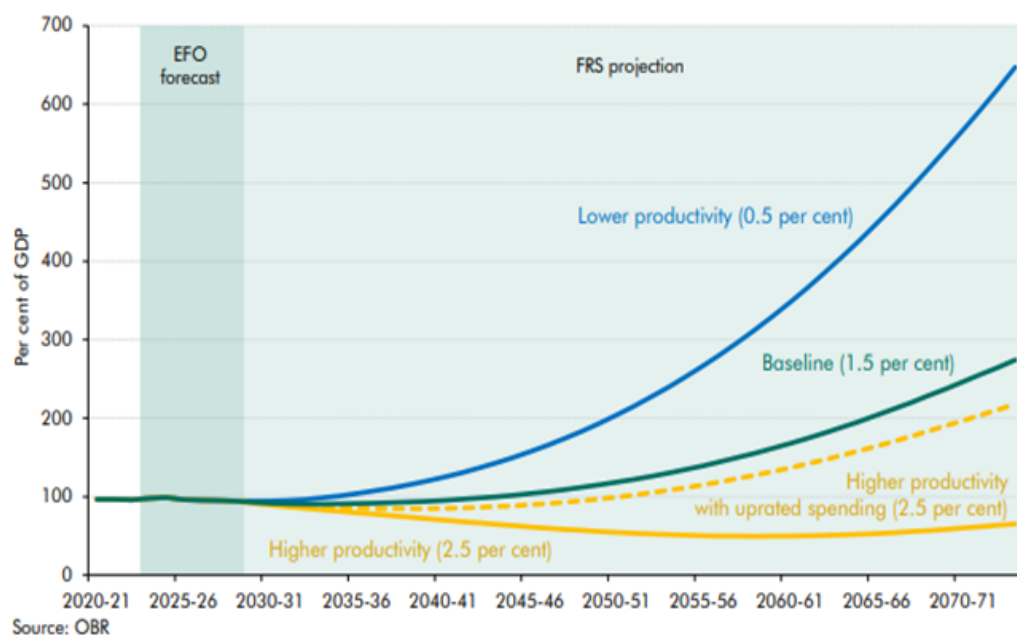
It is notable that while Japan's debt-to-GDP ratio has been well in excess of levels that can suppress economic growth for a considerable amount of time, this is not an appropriate example to compare to the UK, or other G7 countries for that matter. Japan's debt-to-GDP ratio has historically been sustained by very high household savings rates that have had the capability to absorb large government debts, something that has not been applicable to other G7 economies^[5].

Debt trajectory

Based on current policies, the Office for Budget Responsibility's (OBR's) analysis would suggest that productivity growth would need to be around 2.5% per annum to ensure the UK's sovereign debt was put onto a sustainable pathway (see Figure 2). It is notable that, since the financial crisis, UK labour productivity has only grown at one fifth of this rate (see Figure 3), and the OBR's latest forecast suggests that productivity growth will only be lifted to 1% growth per annum in the second half of this decade. The adoption of artificial intelligence does have the potential to boost productivity growth, particularly in the 2030s, and there are examples of bullish estimates that suggest it could add up to 1.5pp annually to productivity^[6]. However, even under the most optimistic scenario, it is reasonable to assume that without policy changes, the UK's debt is on an unsustainable trajectory in the long term, as is the case with many other G7 economies. Recent developments in the UK political scene will no doubt reinforce concerns about long-term debt sustainability. The government has just had to retreat from its proposed reforms to welfare, leaving Chancellor Rachel Reeves with a larger fiscal gap if she is to meet her fiscal rules at the Budget later this year. The government's current poor opinion poll ratings will no doubt make it difficult to implement any further reforms this decade that will either curtail welfare spending or, indeed, to pursue supply side reforms that may encounter severe resistance from a wide range of interest groups.

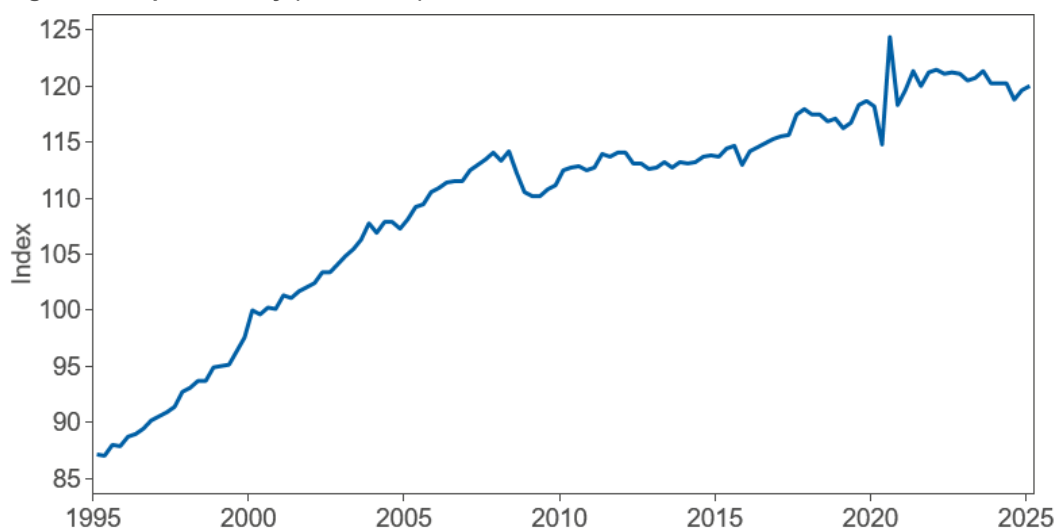
Based on current policies, productivity growth would need to be 2.5% per annum to ensure UK government debt is sustainable in the long term, which is five times the average level observed following the Global Financial Crisis

Figure 2: Debt sustainability analysis



Source: UK Office for Budget Responsibility

Figure 3: UK productivity (2000 = 100)

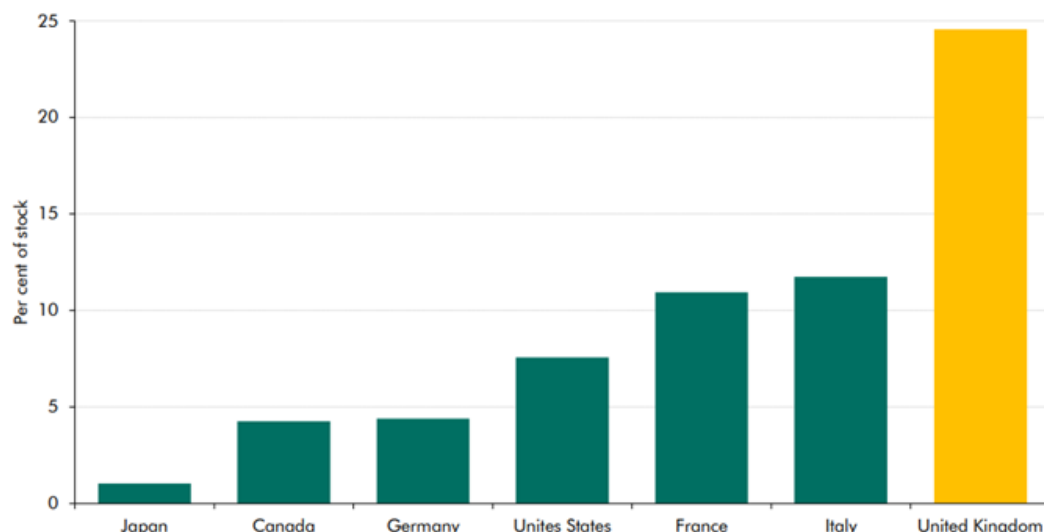


How does the UK fare compared to G7 counterparts?

The UK does have some specific issues relating to its debt stock. The first is the simple point that interest rates on gilts are notably higher than rates paid on European sovereign debt, although note that this is a reflection of financial market assumptions of inflation rather than any judgement on sovereign default risk. The second relates to how the UK's debt is structured, which poses specific vulnerabilities: for example, the UK's debt stock has a disproportionate number of index-linked bonds (see Figure 4). While this has provided some benefits in terms of increasing the duration of UK government debt, it exposes the UK to high interest payments at times of elevated inflation; moreover, a large level (around 25%) of UK Government debt is owned by foreign investors, which makes the UK's debt stock vulnerable as these investors are less inclined to have a structural desire for Sterling-denominated assets^[7]. That said, the UK's overall debt-to-GDP ratio is the second lowest in the G7. Moreover, credit ratings agencies and financial market participants rank the UK's debt sustainability relatively favourably compared to other G7 countries. Credit ratings agencies rank the UK's government debt sustainability as third highest in the G7^[8], and Credit Default Swaps markets price in that the UK government has the second-lowest chance of default within the G7^[9], likely in part due to the ability for the UK to issue its own currency.

The UK's debt structure poses some specific vulnerabilities, but sovereign default risk is perceived to be lower in the UK than in most other G7 countries

Figure 4: Proportion of index-linked government bonds by G7 country



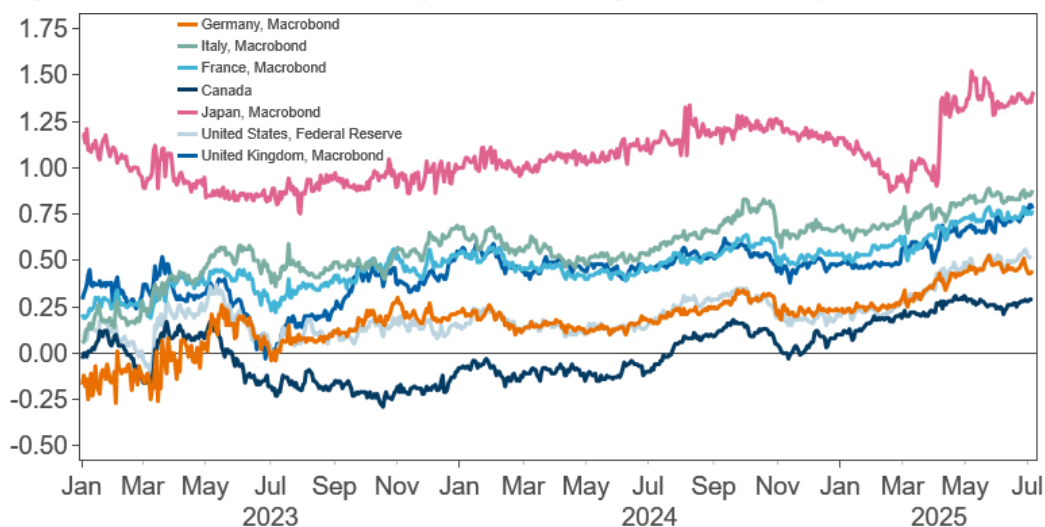
Source: HM Treasury

Financial markets pricing in fiscal sustainability risks via higher term premium

The term premium is the compensation investors demand for bearing growth and inflation risks, when investing in assets with longer maturity instead of short-dated ones. Today's challenged public finance situation is also contributing to the term premium. This is due to the fact that there is now considerable risk and uncertainty associated with future lending needs to governments, including the UK's government. The "term premium" is something that is not directly observable, but one simple proxy is to compare the difference between 30-year and 10-year government bond yields. It is notable that, according to this metric, the term premia for the UK and other developed economies has been on an upward trajectory since 2023, and this upward trajectory was somewhat accelerated in 2025 as investors began to express more concerns about fiscal sustainability of US government debt (see Figure 5). For context, the absolute level and trajectory of the term premia for gilts has roughly been in line with French Oats since 2023.

Since 2023, financial markets have been expressing worries about fiscal sustainability associated with government debts by demanding a higher term premium

Figure 5: Term premia for G7 sovereign debt (30Y-10Y government bond yields)



Source: Macrobond

Financial markets to continue demanding increased term premia in UK gilt market

Current policy in the UK leads to an unsustainable debt trajectory, as is the case with most other G7 countries. However, the implicit assumption by financial markets has been that reforms will be forthcoming to correct the fiscal sustainability trajectory, although the rising term premia demanded by investors suggest that there is now nervousness with respect to this. After the government's recent climbdown on welfare reforms, this nervousness will likely persist given that Chancellor Rachel Reeves is now on course to have a significant fiscal gap to fill at the Budget next year.

It is notable just how severely financial markets reacted to perceived instability in the government, with the 30-year gilt yield jumping by around 20 basis points at one point on Wednesday, 2 July when there was a perception that Keir Starmer may not support his Chancellor. Of course, gilt markets are still prone to jitters in the aftermath of the 2022 mini-Budget episode, and yields have since retreated as the Prime Minister has subsequently overtly backed his Chancellor. This correction in financial markets may, however, prove premature given the persistent underlying concerns about fiscal sustainability, especially since the new political context will make it challenging for this government to implement measures to curtail welfare spending, and its supply-side reform agenda will face significant opposition from a variety of interest groups.

Our interpretation of this is that the current term premia priced by financial markets on UK gilts are likely to be sustained, or could even increase as this decade progresses, given worries about fiscal sustainability are likely to persist. Policymakers will therefore have to remain vigilant with respect to government borrowing costs, especially at the long-end of the market.

The new political context in the UK could make it challenging for the government to alter the pathway of debt onto a more sustainable footing - current term premia priced by financial markets on UK gilts are likely to be sustained, or could even increase as the decade progresses

Footnotes

- 1 Willems and Zettelmeyer, [Sovereign Debt Sustainability and Central Bank Credibility](#), December 2021 ↵
- 2 Blanchard, [Deciding when debt becomes unsafe](#), March 2022: ↵
- 3 Reinhart and Rogoff, [Growth in a Time of Debt](#), May 2010 ↵
- 4 Caner, Grenne and Koehler-Geib, [Finding the Tipping Point - When Sovereign Debt Turns Bad](#), July 2010 ↵
- 5 University of Pennsylvania, [When does federal debt reach unsustainable levels?](#), October 2023 ↵
- 6 Goldman Sachs, [AI is showing "very positive" signs of eventually boosting GDP and productivity](#), May 2024 ↵
- 7 Office for Budget Responsibility, [Fiscal risks and sustainability](#), July 2023 ↵
- 8 Based on Moody's rankings from June 2025 ↵
- 9 Based on data from Bloomberg ↵

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