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# POLICY COMPASS

# Gilt Market Turbulence, Sterling Weakness, & Labour's Fiscal Test

## By

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**2 October 2025**

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## Executive Summary

- UK gilt yields hit 5.72%, the highest since 1998, while sterling slid to $1.338, signalling market concern over fiscal credibility beyond global trends.
- Rachel Reeves' fiscal rules and rising borrowing costs leave limited room to manoeuvre, with possible tax rises of £18–28 billion needed in the Autumn Budget.
- The Bank of England's quantitative tightening compounds gilt volatility, despite recent efforts to slow sales.
- Starmer's appointment of Minouche Shafik reassures markets but signals caution over bold economic strategy.
- Weak productivity and political ambiguity create space for populist narratives, with figures like Farage and Musk poised to exploit any Budget misstep.

### Key Picture: 30 Year Government Bonds Yield


*Source: Options Desk*

### 1. Introduction

The United Kingdom (UK), once again, faces a crisis in market confidence. In early September 30-year gilt yields rose to around 5.72%, their highest since 1998.[1] Concurrently, sterling fell to $1.338, its weakest since April, amid ongoing global trade tensions initiated by Trump.[2] These twin shocks simultaneously constrain the current government and allude to the spectre of past crises. A particularly discomforting parallel being the Truss mini-budget of 2022, when a loss of fiscal credibility caused market chaos.

This surge in yields suggests an isolated domestic issue as opposed to merely reflecting global fiscal trends.

While long-term rates have risen elsewhere, the UK's 30-year gilt now trades above United States (US) Treasuries and German Bunds, two low risk benchmarks, highlighting domestic factors driving yields.[34] There is concern over whether the labour government can manage debt while adhering to its own strict fiscal rules.[5] Borrowing pressures may force Chancellor Rachel Reeves to consider significant tax increases in the range of £18-28 billion in the upcoming Autumn Budget.[6] Alongside this, ongoing quantitative tightening by the Bank of England (BoE) compounds strains on the gilt market, leaving fiscal and monetary forces at odds.[7]

The upcoming Autumn Budget therefore serves as a significant test for Reeves (and the Labour Government) in demonstrating authority and political courage. It also, however, presents a precarious potential tipping point, in which a misstep could worsen borrowing costs and further weaken sterling.

### 2. Rising Yields & Sterling Risk

While yields have climbed in other advanced economies, the UK's 30-year gilt now trades well above US and German equivalents. Investors are concerned that government borrowing plans may be unsustainable,[89] particularly given the large sums required to meet fiscal rules. The prediction that Reeves may need to raise £18-28 billion, in order to ensure debt falls within five years, adding to pressure on fiscal authorities.

The gilt supply-demand imbalance is compounded by the BoE's balance sheet adjustments. The BoE recently slowed quantitative tightening, cutting annual gilt sales from £100 billion to £70 billion, in an attempt to reduce market volatility, including gilt turbulence.[10] While this provides some temporary relief, BoE officials still caution that structural pressures, including weaker demand from pension funds and elevated government debt issuance, persist.[11] Therefore, gilt markets remain vulnerable.

The impact on sterling is evident. Its drop to $1.338 amplifies imported inflation pressures, as energy and food cost rise[12], while concurrently eroding foreign investor confidence, further compounding gilt yields. Capital flows, currency depreciation, and borrowing costs interact in a feedback loop, thus intensifying the macroeconomic challenge if structural issues remain. In preparation for her Autumn Budget, these dynamics will underscore the urgent need for Reeves to implement a credible fiscal strategy to restore investor confidence and stabilise the pound.

### 3. An Overemphasis on Digital Asset Growth

Digital innovation and financial technology are increasingly being discussed as potential levers to stimulate growth. In recent years, both major parties and industry groups have promoted views that digital-asset regulation can act as a growth engine. The government previously declared that the new crypto-asset rule would "drive growth, innovation and security," while Labour's Economic Secretary Tulip Siddiq echoed ambitions for the UK to become a global hub for digital assets.[1314] The cross-party Crypto and Digital Assets APPG similarly frames regulation here as the route to unlocking innovation and competitiveness.[15]

While the UK's regulatory bodies too, such as the Financial Conduct Authority, actively champion technological innovation and the adoption of digital assets[16], their capacity to drive sustainable economic growth is inherently limited. In practice, regulators can facilitate market efficiency, enable tokenisation, and support fintech adoption, however, they cannot generate the kind of fiscal credibility on their own that stems from the necessary public policy decision Reeves' is faced with. Economic expansion depends on areas within the remit of the government rather than regulators.

### 4. Reeves' Fiscal Discipline Dilemma

Rachel Reeves' entered office alongside promises Labour would restore fiscal discipline by ensuring debt falls as a share of GDP within five years.[17] These fiscal rules however, designed to reassure markets of stability, constrain her reaction to current pressures.

These rising gilt yields have caused a sharply increased borrowing costs, consuming her fiscal 'headroom'.[18] There is, therefore, concern that her outlook is "on a knife edge", with higher borrowing costs leaving limited room to manoeuvre within without tax increases or spending restraint.[19]

The Office for Budget Responsibility (OBR), the UK's independent fiscal watchdog, has become a key source of tension. Reports suggest Treasury officials are pressuring the OBR to adopt more optimistic assumptions about productivity growth, since a gloomier outlook would shrink Reeves' already narrowing fiscal 'headroom' and force more difficult decisions.[20] Concurrently, political pressures mount. Trade unions have criticised Reeves for holding back on welfare spending, warning that the fiscal restraint is impacting working families. Within Labour, backbench MPs are signalling they could rebel if her Budget is seen as pushing "down a path of austerity".[21] These combined pressures leave Reeves navigating between market discipline, forecasts underpinning her credibility, and pressure from allies demanding greater flexibility.



A failed Budget would not only undermine market credibility but also jeopardise Reeves' position within the Cabinet. Starmer's decision to move key Treasury allies into No. 10 suggest contingency planning, which reinforces perception Reeves' may be under scrutiny, especially if fiscal credibility alters further.[22]

## 5. Starmer, Shafik, and Economic Advisors

Keir Starmer's early September reshuffle marks a significant recalibration. Minouche Shafik, a former deputy governor of the BoE, IMF official, and LSE director, was appointed as Chief Economic Advisor, while Darren Jones was appointed the role of Chief Secretary to the Prime Minister.[23][24] The government framed these moves as strengthening credibility ahead of a precarious Autumn Budget.[25]

Shafik's international reputation and technocratic expertise provide a ballast to markets in a moment when fiscal credibility is fragile. However, there are questions as to whether this represents courage or caution. Shafik's career across elite institutions would suggest a move to reassurance, therefore she is unlikely to champion policies that challenge entrenched interests or experiment with strategy.[26]

There is a question then of whether these appointments signal of Labour a contentment with technocratic credibility over advocating more disruptive economic strategies. A bolder government may have turned to more heterodox economists. Starmer's choices, therefore, imply consolidation rather than an intent to chart new growth paths.

## 6. Productivity, Populism, and Tech-Pivots

Britain's productivity growth has been stagnant for over a decade, a reality, in the eyes of some, consolidation and technocratic credibility may not prove a suitable veneer for. According to the House of Commons Library, labour productivity fell 0.6% in Q2, 2025 relative to the prior quarter and remains only 1.5% over pre-pandemic levels.[27] In the longer term annual growth in GDP per hour worked has averaged just 0.5%.[28] Analysts point to chronic underinvestment, weak diffusion of innovation across firms, and disjointed policy coordination as fundamental constraints.[29] These structural weaknesses limit the scope for expansionary fiscal policy, which is limited further by rising gilt yields.

In public discourse, where once a dominant framework for explaining economic downturn, Brexit appears to have receded somewhat as an immediate explainer. This apparent absence, or fatigue, creates a vacuum that populist actors like Nigel Farage are poised to exploit economic frustrations. Nigel Farage's party, for instance, has framed stagnation as elite failure, while commentary suggests Musk's backing of Advance UK (a new UK far-right party) reflects a willingness of global tech actors to influence political outcomes when institutional growth strategies appear stalled.[30][31]

Structural economic underperformance constraints fiscal flexibility, this combined with political ambiguity on key causes leaves voters susceptible to alternative narratives.

Within this political quagmire, highly visible actors can amplify narratives to reshape political discourse around growth. For the Labour government then, this underscores the stakes of the Autumn Budget, as missteps in communicating credible growth could inadvertently strengthen populist messaging, impacting both the political and market environment. In practice then, the government must contend not only with rising gilt yields and the resulting constraint of fiscal 'headroom' but also with the risk of populist narratives becoming entrenched as a result of faltering credibility.



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