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Why do UK Gilts always yield more than German Bunds

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Few weeks pass in the UK without reference to ‘fiscal rules’ or ‘headroom’ on our televisions. The panic created by Liz Truss’s short-lived premiership lives long in the memory for us all. This week witnessed another such example of panic in the government bond market (the Gilt market) over fiscal rules and we feel it appropriate to distinguish between previous rises in UK Gilt yields and the current one, and to explain why the UK will almost always have higher yields than similarly sized economies such as Germany.

In simple terms, UK government bonds are generally more susceptible to policy changes than in other countries, such as German government bonds (Bunds), due to differences in fiscal frameworks, political stability, and investor perceptions of risk. This is nothing new.

The question is: why do Gilts pay higher interest rates than other countries such as Germany and is this sustainable? In economic theory, the yield on a Gilt should be driven by the following four factors:

Component	Description
Expected Real Rate	Compensation for time value of money, excluding inflation
Expected Inflation	Compensation for anticipated inflation over the bond’s life
Time Premium	Compensation for risks associated with longer maturities
Inflation Risk Premium	Compensation for uncertainty about future inflation

In practice, day to day UK Gilt prices are actually driven by many factors, including:

Fiscal Policy Volatility: The UK has a history of more frequent and sometimes abrupt fiscal policy shifts, such as the notable market turmoil following the “mini-budget” of September 2022. This volatility can lead to sudden changes in investment sentiment and higher risk premiums on UK Gilts.

Short-termism in Fiscal Planning: UK fiscal rules often treat investment spending the same as day-to-day spending, leading to a tendency for public investment to be cut during periods of fiscal tightening. Successive Chancellors of the Exchequer set the fiscal framework for the term of their government. This creates uncertainty for investors, as planned investments can be cancelled easily, increasing perceived risk.

Safe Haven Status: German Bunds are widely regarded as a “safe haven” asset, especially during periods of international uncertainty. Unlike in the UK, the German fiscal framework is a matter for the Bundestag to determine by vote in the German parliament. This status is reinforced by strong demand from risk-averse investors, which helps keep yields stable even during policy changes. In contrast, UK Gilts do not enjoy the same level of safe haven demand, making them more reactive to domestic policy shifts.

UK Gilts have always been more sensitive to policy changes due to less predictable fiscal frameworks and weaker safe haven status compared to countries such as Germany. BUT, this is not what drives the yield level over time. The four factors listed in the table above are most important and it just so happens that the UK has higher yields because the expected real interest rate, expected inflation, time (risk) premium, and inflation risk premium are higher in the UK than most developed countries. No one Chancellor will change this basic structural outcome.