The World Confronts the "Higher for Longer" Era

A decade ago, economists debated if ultra-low interest rates were a permanent feature of modern economies. Today the urgent question is how long rates will remain elevated worldwide.

In October, the US 10-year Treasury yield hit 4.9%, its highest since 2007. The 30-year yield topped 5%, prompting declarations that rates were rising off "5,000-year lows." For debtors used to cheap credit, this shift to durably higher rates brings daunting challenges.

The belief that this new era of "higher for longer" is entrenched and also is spreading globally. The eurozone saw negative rates in 2021 but now pays nearly 3% on 10-year German debt. Britain mirrors US yield levels. Even Japan faces rising bond yields, defying expectations its rates would stay low indefinitely.

If markets are right, the consequences across economies and societies will be profound. Households and firms will pay more to borrow. Financial systems will undergo wrenching change. Budgets will divert more revenue to cover interest costs. This toxic mix threatens growth.

The US and global economy have so far proved resilient, surprising economists anticipating imminent recession. But several supports buttressing growth look temporary.

Consumers continue spending excess savings built up during lockdowns, but these buffers will eventually deplete. High corporate debt costs will then bite hard, even for firms that locked in low rates. Housing markets will cool as rising mortgage rates make purchases unaffordable for many.

Banks are also exposed, holding long-term bonds financed by short-term lending. Many may need to raise capital or merge to offset losses on devalued bond holdings.

Government fiscal stimulus has boosted growth but is unsustainable long-term. Budget deficits across major economies run between 5-7.5% of GDP despite low unemployment, risking runaway inflation.

As rates rise, towering interest bills are consuming budgets. This strains relations between spendthrift governments and independent central banks mandated to control inflation regardless of fiscal impact.

If higher rates endure, investors may doubt authorities can maintain price stability and service debts. The risk is a self-reinforcing loss of confidence leading to stagflation and financial chaos.

The saving grace is a productivity boom that makes higher rates manageable. Tech advances like AI could lift incomes and corporate revenues enough to offset rising costs. But productivity also faces threats.

Geopolitics boosts the chance of protectionism and industrial policies distorting markets. Rapid aging necessitates more social spending. Conflicts require larger defense outlays.

Overall, achieving the combination of strong growth, moderate inflation, high debts and elevated rates that markets expect seems unlikely. Either growth falters, forcing central banks to cut rates, or productivity surges, offering an escape route.

Policymakers should prepare prudently for less cheerful scenarios by tightening budgets and ensuring ammunition for the next downturn. The stakes are immense in navigating today's uncharted monetary climate.

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