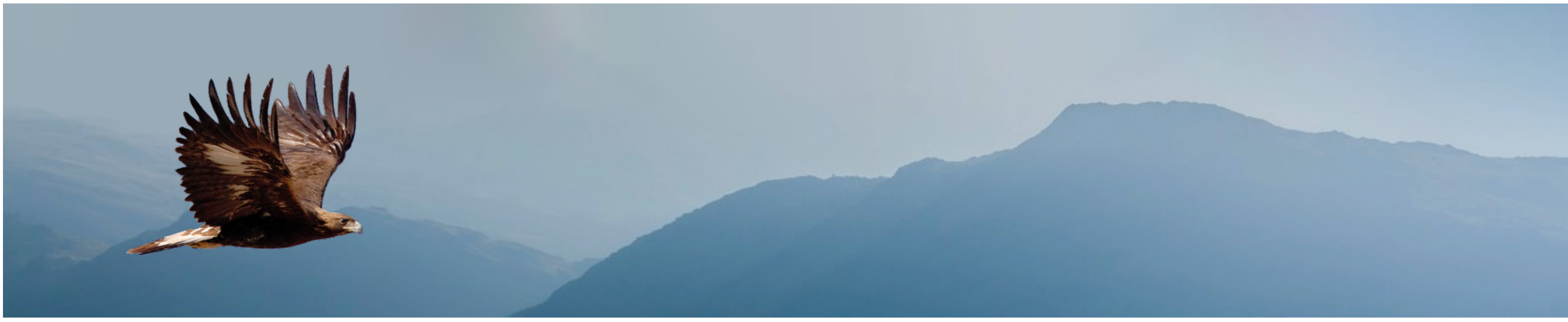

Higher Rates Threaten the World's Economic High

The global economy has defied expectations this past year, growing strongly despite high inflation and interest rates. But new threats loom as the foundations supporting today's growth look unstable.

America's GDP expanded at a stunning 4.9% annualized in Q3 2022, confounding forecasts of an imminent recession. Inflation worldwide also appears to be declining from peak levels, unemployment remains low, and major central banks have paused their rate hikes. This has fueled optimism that the worst is over. Stocks rallied sharply last month.

However, the current optimism may be misplaced. The high interest rates needed to curb inflation are likely to persist and undermine growth. When combined with unsustainable fiscal policies, higher rates for longer point to trouble ahead.

Consumers have propped up demand so far, still spending excess savings accumulated during lockdowns. But eventually these buffers will be depleted. High borrowing costs will then bite hard, forcing consumers to rein in spending.

Many companies already face rising bankruptcies, even those with long-term low rate debt. As rates stay elevated, more will struggle with higher financing expenses. Mortgages are surging, presaging a cooling housing market.

Banks holding long-term bonds financed with short-term lending also look vulnerable to rate-induced balance sheet holes. Some may need to raise capital or merge to offset the damage.

Government fiscal largesse has added to the sugar high but looks unsustainable. Budget deficits in major economies are running between 5-7.5% of GDP. With unemployment low, such immense borrowing is imprudent.

Rich world debt as a ratio of GDP is at heights not seen since after the Napoleonic wars. As rates rise, towering interest costs are consuming budgets. This pits governments against independent central banks mandated to control inflation regardless of fiscal impact.

If higher rates persist, investors may question whether authorities can maintain price stability while also paying down debts. The risk is self-reinforcing stagflationary spirals and debt crises.

Productivity growth is the saving grace that could make higher rates manageable. Tech advances like AI may boost incomes and corporate revenues to offset rising costs. But productivity faces its own threats.

Geopolitical tensions increase the likelihood of trade barriers and industrial policies distorting markets. Rapid aging necessitates more social spending. Defence budgets are climbing amid global conflicts.

Overall the world economy seems unlikely to achieve the combination of strong growth, moderate inflation, high debts and rising rates that markets currently expect. Something will have to give.

The most likely trigger is economic weakness forcing central banks to cut rates, despite inflation overshooting targets. More hopefully, a productivity boom from AI and tech innovation could provide an escape hatch.

But betting on the rosy scenario is risky given the stakes. Policymakers should prepare prudently for a less cheerful outcome by tightening fiscal policies and ensuring they have ammunition to counter the next downturn.