Rising Long-Term Interest Rates Pose a Challenge to the Global Economy

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Rising long-term interest rates have become a major challenge for the global economy. The increase reflects a combination of factors, including inflation and fiscal expansion in advanced economies, as well as growing competition for capital driven by investment in artificial intelligence (AI). How should we interpret the current rise in interest rates, and how should policymakers respond? We spoke with experts in financial markets and monetary policy.

A Fiscal Crisis Is Possible Even in Advanced Economies

Maurice Obstfeld | Former Chief Economist of the International Monetary Fund

There are two major structural developments behind the global rise in interest rates.

One is the persistence of government deficits and the upward drift of public debt levels around the world. The United States is notable, but it is a worldwide phenomenon, and I think that's putting pressure on interest rates globally.

The other big development has been the AI buildout and the resulting demand for investment resources. Recently, hyperscalers have been turning to credit markets rather than funding their investments out of cash flow. They've been borrowing aggressively and borrowing globally.

The prospective expenditures on data centers and related technologies over the next decade are absolutely huge.

Those resources have to come out of global savings. To raise global savings to an adequate level to fund that investment, interest rates have to go up.

I still believe there are powerful long-term demographic forces putting downward pressure on interest rates. But in recent years, other forces pushing interest rates higher have become increasingly important.

Population aging tends to raise saving around the world, while shrinking populations tend to discourage investment and productivity growth.

These long-term "low-for-long" forces are still there. But they could be disguised for some time by the pressures of public budgets and AI investment and deployment.

I would be surprised if we're not living with higher long-term interest rates for at least the next five years, maybe longer.

Now, what could change that would be the emergence of a recession or the collapse of a financial bubble. Typically, those events do depress real interest rates, so one doesn't want to be too confident. There can always be a macroeconomic event that leads to a substantial recession.

Central banks will also have to respond to this changing environment.

One implication is that neutral rates of interest are higher than they used to be. It's going to be a challenge for central banks to keep track of possible movements in the neutral rate.

I think for the United States, policy interest rates have probably been below the neutral rate, and that's one reason we've seen persistent inflation.

The recent series of bad inflation outcomes from various data releases provides strong evidence that the neutral rate is a lot higher than it used to be.

There is also a positive side to having reasonably positive and sustainably positive real interest rates.

If we look at the real interest rate in the United States now, it is not high at all by historical standards. Real interest rates have more or less returned to the levels of the early 2000s, when we were talking about a global saving glut.

Having very low real interest rates means there's less market discipline, and that's not a good thing for financial stability. Sustainably positive real interest rates can be beneficial.

The main downside in the current environment is that government debts got so big during the era of low and negative real interest rates.

This rather sudden jump upward in real interest rates poses a fiscal challenge. Governments in many countries are finding it very hard to meet because the politics of fiscal adjustment necessarily require inflicting pain on voters, and voters are not really willing to volunteer for that kind of pain.

A fiscal crisis is possible even in advanced economies.

In the United States, I think outright default is very unlikely. But if we saw a sharp rise in Treasury borrowing rates and an unwillingness of markets to accept debt at auction, then that would be the equivalent of a fiscal crisis.

That raises the question: What does the Federal Reserve do in that situation?

It seems most likely that the Fed would step in in some way and argue that it was protecting the functioning of markets.

But that might just be a cover for effectively helping out the government, and it would also potentially be inflationary.

Even in the not-too-distant future, the United States is facing the prospect of insolvency problems for Social Security and Medicare.

And among the topics being discussed by both parties, fiscal threats are not being discussed by either party. There just seems to be no policy interest at all in fiscal prudence.

To be politically realistic, campaigning on fiscal consolidation is probably not a winning strategy.

But my view is that, acknowledging that there are valuable things they might want to spend on, policymakers should have a long-term plan for reducing the debt-to-GDP ratio, or at least stabilizing it, and putting Medicare and Social Security on a firm footing.

I think those discussions need to be happening, and I don't see evidence that they are.

Interview by Yoshikazu Imahori

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