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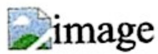

Two Reasons Low-Rate Era Is Over

CAPITAL ACCOUNT

By Greg Ip

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The Federal Reserve three weeks ago slashed its shortterm rate target by half a point and signaled more cuts to come. Yet in that time, investors have pushed the yield on the 10-year Treasury to 4%, the highest in two months.

Why would long rates rise while the Fed's rates fall? The Fed sets interest rates for the immediate future. Investors are betting on the path of those rates for the next decade. And for two reasons, interest rates are likely to be higher, perhaps much higher, in the coming decade than in the prior one.

One of those reasons is relatively benign. Inflation and growth won't be as low as before the pandemic. The second is much less benign. The federal debt is on an unsustainable path, which might become even more perilous after the election, especially if former President Donald Trump wins and Republicans take control of Congress.

More than a year ago, the Fed pushed its rate target range to a 20-year high of 5.25% to 5.5% to make sure inflation didn't stay stuck above its 2% target, even if that meant causing a recession. By September, inflation was closing in on 2%. The half-point cut signaled that the Fed's priority was now protecting the labor market.

Then, last week's September jobs report at a stroke changed the picture of the labor market from deterioration to robust health.

The Fed's pivot, and the jobs data, drastically reduced investors' expectations of a recession that would force the central bank to slash rates deeply in the next year. That alone would merit higher long-term rates.

Meanwhile, it's possible economic growth will clock in at a surprisingly brisk 2.8% pace over the past four quarters. That would suggest that the economy has become less vulnerable to higher interest rates. In economists' jargon, the "neutral rate," which keeps inflation and unemployment stable, has apparently risen. As recently as December, Fed officials thought neutral was 2.5%. By September, they had raised that to 2.9%, and some officials had put it at 3.5% or higher.

By itself, a higher neutral is nothing to worry about (though maybe not if you're trying to get a mortgage) because it signals a return to normalcy.

But in combination with the soaring federal debt, it could cause trouble. Since 2007, the federal debt has climbed from 35% of gross domestic product to 98%. Much of this was a result of the 2008-09 financial crisis and Covid-19. The borrowing didn't put much upward pressure on bond yields because inflation and the neutral rate were so low.

Yet in the past fiscal year, Washington borrowed $1.8 trillion. At 6.4% of GDP, that's a record outside of war, recession or crises such as the pandemic. Interest expense is climbing steadily. The Congressional Budget Office projects that under current law, publicly held debt will hit 122% of GDP in 2034.

The effect on long-term rates has been largely invisible thus far. It might become more visible before long.

Both Vice President Kamala Harris, the Democratic candidate for president, and Trump, her Republican opponent, have proposed lavish spending and tax cuts that would add significantly to the debt.

The nonpartisan Commit--tee for a Responsible Federal Budget has estimated the debt impact at $3.5 trillion for Harris and $7.5 trillion for Trump from 2026 through 2035.

"Neither has anything close to a plan to deal with the overall debt, but clearly the Trump agenda would be significantly worse than the Harris agenda," said Maya MacGuineas, president of the CRFB.

Trump's plans not only are more costly than Harris's, they also are more likely to be enacted.

President Biden and Harris certainly had no compunction about running up debt for their spending priorities. Still, if Harris became president, Republicans are strongly favored to take back control of the Senate, where they would likely block most of her costly spending plans. Even within her own party, Harris doesn't command the personal loyalty that Trump does with his.

"The likelihood of Harris getting what she wants is far less than the likelihood of Trump getting what he wants, because she will not have the impact on Democrats that he has on Republicans," said Bob Corker, a former Republican senator from Tennessee.

Under Trump's influence, the debt has steadily receded as priority for Republicans. He banished any talk of cutting Social Security or Medicare benefits, the deficit's two biggest long-term drivers.

Much of the tax cut Trump signed into law in 2017 expires at the end of 2025, teeing up a major new tax bill early in the next president's term. He wants to make its provisions permanent, which could cost an estimated $4 trillion over 10 years, not including his other proposed tax cuts. Even if Trump doesn't get all he wants—repealing taxes on Social Security benefits is a particular stretch—he could get a lot of it.

Investors might then start to pay attention.

There's no good way to predict the impact, if any, on U.S. interest rates. Research has found that bond yields rise by 0.01 to 0.06 percentage point for each 1% of GDP the debt rises, according to a review in a recent Fed paper. When those estimates are applied to the CRFB's various scenarios for debt by 2036, that could imply anything from 0.25 to 2 percentage points.

Other factors also matter. Higher inflation would aggravate the deficit's impact on interest rates; lower inflation, a demand for bonds by an aging population or panicked investors would soften it.

And yet U.S. debt is clearly entering uncharted territory. A recent study by the Penn Wharton Budget Model suggested that even though the U.S. controls its own currency, its debt would become unsustainable as it approaches 175% of GDP. We're not there yet in the coming decade we could be getting close.

Said Corker: "For those who hope for even a modicum of fiscal responsibility, pray for divided Congress."

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