**Do rising bond yields suggest a new economic and financial crisis is imminent?**

**Vicky Pryce**

Here we go again. 10 year bond yields have risen to the highest level since 1998 in the UK – and are now higher than they were during the brief premiership of Liz Truss and thechaos caused by her unfunded mini-budget of September 23, a year ago. And it isn't just a UK phenomenon as it was then. What we are witnessing is a 'global bond market rout' that has pushed rates up to decade highs across the world. It is happening in the US, Japan and across the Eurozone too.

Why is that? The exact reason differs from country to country,but the common denominator is an expectation that interest rates will stay high for longer because inflation is difficult to tame. On top of that it is clear that with government debt in most countries having zoomed up during Covid and later through the need to support the economy following the energy price hikes from the war in Ukraine, the perceived risk of holding on to that debt has increased. The means that interest rates on government bonds need to be higher to compensate for this, especially if growth projections are being reduced.

In the US, whose economy is doing better than most advanced nations and where inflation is half the UK's, thenegative sentiment is exacerbated by hawkish language from the Federal Reserve helped also by better than expected data on US jobs openings in August. Additionally, US Treasury yields are rising reflecting concerns about the continuous problems of the government struggling to function within the constraints of the constitutional debt ceiling, which at regular intervals threatens to limit ability to borrow and spend.

In the UK the debt worries are added to by the fact that a quarter of the debt is index- linked which means that inflation is pushing the cost of government debt even higher. And here, as elsewhere, the situation has been exacerbated by the unwinding by central banks of Quantitative Easing (QE) which they engaged into during Covid. That had consisted of buying huge quantities of government bonds, bringing the yields down to practically zero, and therefore lowering the cost of borrowing for both the public and the private sector.

Now the opposite is happening. Most Western central banks have been steadily offloading those bonds. That is known as Quantitative Tightening (QT) and in the process is bringing bond prices down and yields up. Unfortunately, this often means that the bonds are sold to the market at a loss which in the UK the Treasury – in other words the taxpayer, is committed to compensate the Bank of England for.

What does it mean for businesses, households and governments? If the Bank of England keeps rates high for longer than originally thought as it is indicating it wants to do, businesses will be tempted to continue trying to pass this extra cost to consumers, thus making the inflation picture worse. And if long term yields don't start declining again soon households will be doubly hit as mortgage costs normally rise in line. The government may be able to benefit partly from the fact that inflation is eating away the real value of its debt. But with its effective borrowing costs having already risen significantly, this will restrict its fiscal room for manoeuvre and the low growth scenario they will then be contemplating will inevitably have a negative impact on its credit rating and eventually the effective interest rate it would have to pay on its borrowing.

But the impact is wider and potentially more dangerous. Those entities which may need to sell the bonds they hold, such as financial institutions, will find that their value has dropped significantly

from when they first bought them, which was what we saw with the pension industry's near meltdown after yields rose sharply following the Truss/ Kwateng mini- budget and which then required emergency Bank of England intervention.  For banks, which are big holders of government bonds, there are probably huge unrealised losses which are worrying investors. Bank share prices in the US for example, which already went through a regional banking crisis in the spring, have been under renewed pressure. More emergency liquidity from the Federal Deposit Insurance Federation may again be required.

But in the meantime, what we are seeing in many countries is tightening of lending conditions to preserve capital ratios. At the same time those able to hold those bonds are reaping big returns in terms of the yields they are earning – no incentive then as cost of capital is going up, to fund instead the productive investments that the economy needs.

Maybe this is just a phase, and the tide will soon turn. But unless monetary authorities start giving a sign that interest rates will be on their way down soon, it is hard to see how that can be resolved in a hurry without doing extra damage to the world economy.

**Vicky Pryce is Chief Economic Adviser and a board member at CEBR, a former joint head of the UK government Economic Service and Visiting Professor at BCU and King's College, London.**