

Do rising interest rates suggest a bubble is about to b...

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The world of finance is getting edgy about something Duncan Weldon noted on the [BBC web site yesterday](#) when he said:

Across the world the cost of government borrowing is rising. The yield (or interest rate) on a 10-year UK government bond (the debt issued by the UK government) has risen from around 1.6% a month ago to 2.0% today.

In Germany the move has been even more dramatic - from around 0.05% to 0.7%. These sorts of moves are being seen in the US, Japan, Australia, Thailand, India and just about any other country one chooses to name.

Now let's be clear what's really happening here, and that is that government bond prices are falling. They have been extraordinarily high, which is precisely why we have had such low rates of interest on government borrowing, because the price of these bonds and the effective interest rate that they pay are the inverse of each other. To make clear just how high the price has been, the [Financial Times notes this morning](#) that there are still \$1.7 trillion of government bonds worldwide that currently pay negative interest rates - that is, people are paying governments to hold their money for them.

But why the shift in rates, representing a significant fall in bond prices? Some are suggesting that this is a simple market reaction: bonds have been overpriced and an adjustment is necessary. This, however, makes little sense. The market is also illiquid at present precisely because there appears to be a shortage of available government bonds to meet investor demand. When it is reported that the largest 50 US companies holding cash have, between them, more than \$1 trillion on deposit because their collected entrepreneurial expertise can find no use for it it is unsurprising that there is a significant demand for bonds, which has in itself created the negative interest-rate phenomenon. If anything the price of bonds should still be rising precisely because there are not enough of them: the paradox that governments are not running big enough deficits to meet market demand for their debt is one we should not miss. How long these contradictory positions can last is hard to tell but the implication is that

instability is possible unless there are changes in policy, to which point I return below.

Secondly, some are arguing that this is simply the portent of a necessary increase in interest rates and that this will, finally, come to pass soon. In a sense this is a self-fulfilling prophecy: whether or not central banks change their base rates if bond prices move significantly then commercial rates will, as a matter of fact, increase with consequent knock-on effect in the business, mortgage and personal lending markets.

Markets have long wished for this increase in rates, describing it as a return to 'normality' (for which read 'pre-2008'). However, no one now knows quite how the real world beyond financial markets will react if interest rates are to rise. As a matter of fact there remains substantial leveraging in much of the economy, including the small business sector and many households, with the risk of default being significant if the mortgage rate increases even slightly in the UK, for example. Financiers might want a return to 'normality' but the truth is that they might get a return to the era of default, repossession and substantial loss provisioning in banks, and it would not be hard for that to tip over into the next financial crisis.

Third, some argue that this is the consequence of quantitative easing. It is said that investors piled into bonds on the assumption that governments were going to buy them whatever the price and so a guaranteed profit was available but that this awareness has now changed and so prices have fallen. The difficulty with this analysis is that there has been no change in policy. The quantitative easing programme of $\hat{a}, -1.1$ trillion is still in place in the Eurozone where many of the bonds with negative interest rates are to be found. Whilst it is true that this programme is designed to create inflation, and so the possibility of positive, and increasing, interest rates, meaning it could be argued that the goal of QE is being achieved at present, the reality is that this was supposed to happen because the increased liquidity that QE should provide to banks was supposed to create extra lending, and so additional demand in the Eurozone, where it has been particularly slack (although latest GDP figures slightly contradict this). This has, however, not appeared to happen. The money that is leaving the conventional bond market, which is the focus of concern of this article, is instead going into the index linked bond market, suggesting that expectations of inflation are real, but that banks are taking no part in trying to create it. Again, the paradox is obvious: tinkering with the finance system to encourage banks to participate in the real economy just does not work. If banks can avoid it they would really rather not deal with anyone outside their sector and they are instead simply playing a game of financial arbitrage.

What to make of all this then? I suggest three things follow.

The first, and obvious, macroeconomic point to make is that there remains a shortfall of demand in the world economy and a significant lack of business investment and so as a result it is essential the governments make up the shortfall in economic activity by expanding their borrowing at this point of time which means that they must run deficits. This is the only solution to the economic situation we are in. The new UK

government's stated policy runs completely opposite to this, and is, therefore, exactly the wrong economic policy to this point in time.

Second, because there is such demand for government debt from private investors conventional quantitative easing is creating significant instability in financial markets at present when it should be doing the exact opposite. Whilst it is necessary, without a doubt, for governments to be pumping newly printed electronic cash into economies, the QE programmes that we have had to date are no longer effective for this purpose simply because there is insufficient government debt available to achieve their aims. In addition, the programme is now being too obviously arbitrated by the financial system for its own gain without any of QE's key objectives necessarily being achieved. The perverse consequence may be instability.

Third, in that case governments must let the supply of their own debt, created through the continued running of deficits, be used to meet market demand for high-quality bonds whilst finding new ways to inject cash into the economy to achieve the dual goals of creating more money to provide market liquidity and fuelling real economic activity. The answer to this is, of course, [green infrastructure quantitative easing](#), as I have long argued. Technically this does create new debt, but in practice it is almost immediately cancelled, but in the process new electronic cash is created for use by government agencies to assist investment that creates the long-term infrastructure improvements that are required by the economy, and which can be financed at present at incredibly low interest rates to provide long-term benefit in terms of employment, growth, enhanced skills, new technologies and more that completely compensate for any potential inflation risk from doing so, and permits growth that would otherwise simply not be achievable.

So in summary, current market conditions, perverse as they are, clearly indicate a change in policy is needed. I sincerely hope someone takes note or instability may follow.