Beyond central bank rates: Why funding costs will remain structurally higher

CAPITAL CONTOURS

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Much attention has been devoted to whether the US Federal Reserve and the European Central Bank will continue raising policy interest rates in response to renewed inflationary pressures, given the reignition of the US-Iran war. While monetary policy remains an important anchor for financial markets, the debate risks overlooking a more profound structural shift, and markets should not make the mistake of equating the policy rate with the cost of capital. Increasingly, geopolitical fragmentation, fiscal pressures, supply chain restructuring and higher risk premia are reshaping the economics of funding. Besides a rising likelihood that policy rates will eventually rise in response to inflation induced by higher energy costs, funding costs may remain structurally higher than in the decade preceding the pandemic.

The protracted conflict in West Asia has once again brought energy security back into focus. Rising oil prices threaten to revive inflationary pressures through both direct energy costs and second-round effects. Central banks will undoubtedly remain vigilant, but the extent to which they tighten policy will depend on whether they view these inflationary pressures as temporary supply shocks or as symptoms of a more persistent structural shift.

More fundamentally, the ongoing conflict illustrates how geopolitical risks have become increasingly complex, difficult to contain and can no longer be assumed as temporary. While there remains an overarching aspiration for some form of ceasefire or negotiated settlement, recent events demonstrate that the regional conflict extends well beyond bilateral negotiations between the US and Iran. The multiplicity of actors complicates any pathway towards resolution. It has proven difficult for the US to fully coordinate Israel's military actions, just as Iran faces constraints in influencing the actions of non-state armed groups. In an increasingly fragmented security landscape, the trajectory of conflict is no longer determined solely by nation states, but also by the strategic calculations of multiple armed actors whose objectives may not always be fully aligned with those of their sponsors.

The economic consequences extend well beyond higher oil prices as a primary source of inflationary pressure. Persistent security risks along key maritime trade routes, particularly through the Strait of Hormuz and the Red Sea, have introduced a structural increase in transportation, insurance and logistics costs. Firms are increasingly compelled to diversify suppliers, build inventory buffers, establish excess capacity in production facilities and invest in cyber resilience to safeguard operations. These additional investments inevitably raise operating costs, and factor into inflation outcomes that comprise the primary locus of central banks' monetary policy decisions. Even where competitive pressures and government intervention through subsidies limit price increases, corporate profit margins are likely to come under strain, encouraging firms to pursue cost rationalisation through measures such as restructuring and automation. From this perspective, the cost of inflation is potentially transformed into the cost of unemployment, implying that geopolitical events cannot be fully neutralised via policy interventions that merely redistribute the economic pain.

The macroeconomic burden of geopolitical conflict enters the funding cost equation as government subsidies, protectionism, industrial policy and defence spending are reallocated to future time periods through the capital markets. Again, the redistributive function of policy then becomes a political economy decision rather than one that yields a positive cost-benefit outcome. While interventions may cushion households and businesses in the near term, they simultaneously place greater pressure on public finances, creating an inter-generational burden. Higher fiscal deficits require increased government borrowing, resulting in larger sovereign bond issuance and, over time, upward pressure on government bond yields. Ultimately, taxpayers finance today's geopolitical instability through elevated public debt and higher taxation over time.

For Malaysia, as a net exporter of hydrocarbons and commodities, elevated energy prices provide a degree of external support through stronger export earnings and fiscal revenues. Yet, these advantages should not be mistaken for permanent structural strengths. Commodity cycles are inherently temporary, while hydrocarbon resources are finite. The current period of relatively favourable terms of trade presents an important opportunity to recycle resource-based revenues into investments that strengthen long-term productivity, diversify the economic base, enhance supply chain resilience and entrench the nation's competitiveness. These economic opportunities explain Malaysia's record-high gross fixed capital formation and foreign direct investment, aligned with optimising capital usage by investing for the future.

Sustaining high economic growth is therefore no longer merely desirable but necessary, as the foundational equation in economics suggests that a higher positive return on investment needs to exceed its (now) higher costs. This reinforces the importance of maintaining robust levels of gross fixed capital formation (that is, investments), particularly in sectors that enhance productivity and technological capability. Malaysia is well positioned to benefit from ongoing shifts in global supply chains, semiconductor investments, artificial intelligence infrastructure and broader technology upgrading. Such opportunities arise infrequently and can even be considered fortuitous, hence converting today's investment cycle into lasting productivity gains is of high urgency, and will determine the country's long-term economic resilience.

Consequently, funding costs are shaped by forces extending well beyond central bank decisions. Strong gross domestic product growth and rising capital expenditure will increase competition for available funding. At the same time, governments confronting higher fiscal deficits and growing public debt will continue issuing larger volumes of sovereign bonds, exerting upward pressure on market interest rates. Meanwhile, beyond fundamental financial statement analysis, lenders and investors must increasingly price evolving risks associated with geopolitical uncertainty, supply chain disruptions, trade fragmentation, currency volatility and sovereign creditworthiness. For emerging markets, particularly those with weaker external balances or higher reliance on foreign capital, these risks may be reflected in higher credit spreads, elevated foreign exchange funding costs and increased volatility in capital flows.

The era of abundant liquidity and structurally low funding costs was underpinned by decades of deepening global trade, expanding multinational supply chains, relative geopolitical stability and the inertia of quantitative easing coupled with zero interest-rate policy by the major central banks. In today's context, the debate should therefore move beyond the narrow question of the next 25-basis-point move by central banks, as history suggests that secular shifts in the cost of capital rarely originate from monetary policy alone. On top of an increasing likelihood of higher interest rates due to inflation, the broader cost of funding, driven by higher risk premia and structural changes in the global economy, is likely to lead to a normalisation of higher funding costs for years to come. E

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