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How Trump and Project 2025 policies could permanently raise interest rates

Today's interest rates are already too high and damaging family budgets and long-term climate and housing goals. But, for now, the Federal Reserve still has the freedom to lower them—an action they should have taken a while ago. However, the policies put forward by Donald Trump and Republican plans like Project 2025 would both drive prices higher and cause chaos and uncertainty in financial markets, putting relentless upward pressure on interest rates that the Fed would have little ability to resist. This uncertainty would stem from two reckless policy goals that Trump and his allies have embraced: political capture of the Federal Reserve and continued weaponization of the nation's debt limit. The economic importance of these reckless policy paths and the extent to which they could cause permanently higher interest rates is often underestimated—especially compared with the effect of more conventional policy debates (like the proper size of the federal budget deficit, for example.)

The first route to permanently higher interest rates: political capture of the Federal Reserve

The first route to permanently higher interest rates would be an unstable and short-sighted president wresting control over the Federal Reserve's decision-making process. The Fed is granted unique levels of insulation and independence so that it can make decisions that are good for the economy at large, even when they are not in the interest of the president or congressional majorities. The previous Trump administration was unprecedently loud (though ineffective) in its criticisms of the Fed, and numerous reports indicate that a second Trump administration would double down in seeking greater control over the Fed. Key Project 2025 architects have railed against independent federal agencies and explicitly called for stripping them of this independence, with strong hints that this includes the Fed.

The most-cited scenario justifying the Fed's independence is one where a sitting president would like lower interest rates to keep the economy running hot as an election nears, even if inflationary pressures are brewing. In this scenario, although the political goal of capturing the Fed is to keep interest rates low, pressure to raise them (and to keep them high for a long time) would become irresistible as inflation spiraled. For proof, just think of how intensely the public reacted to recent years' inflation and how the Fed raised interest rates more sharply than they have in decades.

Further, if it became widely recognized in financial and labor markets that the Fed had lost its ability to rein in a fast-growing economy even when inflationary pressures were building up, then “inflation expectations” might begin rising. Over the last few years, stable inflation expectations were one useful bit of economic context that allowed historically rapid disinflation without much weakening at all in the labor market. In the future, shocks like the pandemic and the Russian invasion of Ukraine could lead to more persistent inflation if these inflation expectations become much less stable—and the way to make them unstable is precisely to have an erratic president take control of Fed policy. More *persistent* inflation stemming from shocks would mean interest rates would have to be held higher for longer.

We should be clear that the existing independence of the Fed has not always worked out great for typical workers. The scenario above, for instance, is often cited to justify the actions of the Fed in the early 1980s when it raised interest rates to 20% and allowed unemployment to reach 11% in the name of fighting inflation. This period—and the impression it generated that keeping inflation low was worth tolerating long periods of high unemployment—was incredibly damaging to U.S. workers, and reflected the Fed being overly influenced by many macroeconomists’ analytical mistakes regarding how its “dual mandate” of creating maximum employment while keeping inflation stable should be balanced.

But for all its flaws and wrong macroeconomic judgments over the decades, the Fed was genuinely independent of partisan political pressure. Even more importantly, it has shown itself recently to be *persuadable* with good evidence. Since the Great Recession of 2008, for example, the Fed has tried to restore the economy back to near-full employment and has tested the limits on how low unemployment can go. Perhaps the Fed has not moved as aggressively as I would have, but they have not engaged in preemptive interest rate hikes in the name of keeping hypothetical inflation at bay. This recent experience shows some of the key benefits of the Fed’s independence—and not just when that independence is allegedly needed to inflict macroeconomic pain in the name of inflation-control. For example, the Fed’s efforts to boost the economy in the 2010s ran directly counter to the Republican-majority Congress and their efforts to slow growth with fiscal austerity.

It would be bad enough if Republicans’ efforts to erode confidence in the Fed only served their own electoral prospects. But, in recent years, they have also been driven by transparently corrupt efforts to repay favors to the finance sector in exchange for campaign contributions. Senator Cynthia Lummis (R-WY) has introduced legislation—the BITCOIN Act—that would force the Fed to buy Bitcoin so the federal government can stockpile a “strategic reserve” of Bitcoins. It is hard to imagine a dumber idea, and it would open a Pandora’s box of corruption as Congress and the president decided they could repay political favors to key financial interests through mandating the Fed buy particular assets.

The BITCOIN Act is near-perfectly designed to convince financial markets, businesses, and the public that the Fed is *not* fully committed to macroeconomic stabilization but has instead been hijacked by political opportunists. It's hard to imagine something more effective in destroying confidence that the Fed will keep inflation near target—and this confidence is needed to keep inflation expectations usefully anchored.

The second route to permanently higher interest rates: outright default on the federal debt

The second route to permanently higher interest rates that Republicans have started down requires much less explanation: They could force a default on the federal debt by refusing to raise the nation's statutory debt ceiling. The debt ceiling is an obsolete and arbitrary institution that is completely disconnected from the nation's actual fiscal health. At this point, it exists solely to provide a veto in Congress to any party willing to cause a national crisis if their policy agenda is not enacted. The last decade has seen repeated near-misses when Republicans have walked to the edge of default in the hope of getting their policy agenda crammed through a Congress that would not have otherwise voted for it.

Because only Republicans so far have been willing to threaten a crisis over the debt limit, they see this status quo as useful for their policy ambitions. For example, the Republican Study Committee in 2023 released a "playbook for debt limit negotiations" that completely embraced the principle of using default as a lever to secure Republican policy demands. To keep allowing the debt ceiling to exist all but assures a crisis in our future, and potentially as soon as January 2, 2025, when the limit will be reached again.

Republicans often like to pose as the party of fiscal "discipline", willing to inflict some pain in the form of cuts to public programs (but never in the form of tax increases on the wealthy or corporations) in order to keep a debt crisis from hitting the nation. Yet the most reliable crisis that can come out of fiscal policy debates is the one that comes from the political weaponization of the debt ceiling—and the Republicans are enthusiastic participants in this.

A debt ceiling breach that genuinely bound new federal spending could cause a rapid and steep recession, as Social Security recipients stopped receiving checks, doctors and hospitals stopped being reimbursed for services provided to patients covered by Medicare and Medicaid, federal employees stopped receiving paychecks, and contractors no longer being paid. Further, this recession would only intensify until the debt limit was raised (or abolished).

In the longer run, even if there was no acute emergency that stemmed from the gratuitous undermining of investors' confidence in the U.S. government's ability to repay debts in a timely manner, this would still lead reliably to higher interest rates throughout the economy. Interest rates on U.S. government debt are the anchor of the world's financial system—

every other interest rate is essentially the rate paid on U.S. government debt plus some mark-ups associated with other forms of debt being riskier. If U.S. debt saw an increase in “risk premium”, then this would ripple throughout the economy. Higher interest rates would lead to higher debt payments for families and reduced investment in new plants, equipment, and capital from businesses, which would stunt productivity growth.

Even small changes in this “political risk premium” are large relative to the effects of other policies. Take one example first highlighted by Ernie Tedeschi in a recent paper—say the United States risk premium rose to the same level as that currently faced by the United Kingdom. It’s a real possibility—the U.K. has many of the advantages of the U.S. (control over their own currency and monetary policy, for example), and yet irresponsible policy ideas floated in recent years saw a rapid spike in their political risk premium. If this happened, interest rates on U.S. debt could rise by 0.8 percentage points. Is this large?

Currently, the nation faces a “fiscal gap” of roughly 2.0-2.5%, which represents how much taxes need to be raised or spending cut as a share of gross domestic product (GDP) to keep the nation’s ratio of public debt to GDP stable. In the past, economists have tried to estimate how much deficits boosted interest rates. One estimate comes from William Gale and Peter Orszag, who find that a *sustained* one-percentage-point increase in deficits would raise interest rates by between 0.2 and 0.4 percentage points. This, in turn, means that the upward pressure on interest rates that could stem from even modest estimates of potential increased political risk would essentially erase any benefits that would be obtained if we somehow completely eliminated the nation’s current fiscal gap.

These extreme policies would hurt working families

In short, the extreme policies that Republicans have already begun pursuing (weaponizing the debt limit for political gain) and that they hope to pursue in future administrations and Congress (political capture of the Fed) have large stakes. For working families who have not liked the high interest rates of recent years, these policy ideas should be seen as most unwelcome and emblematic of why Republican administrations generally preside over much weaker economic performance than Democratic ones.