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A toxic mix: Trump, debt and inflation

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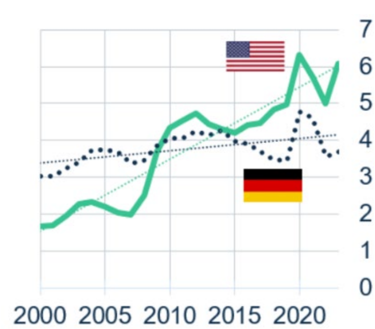
Trump's economic plans could threaten global financial stability

This month, I had the pleasure of attending the 25th-anniversary celebrations of LBBW in New York. It was not only a festive occasion, but also an opportunity to engage with local U.S. economists. Regardless of where our conversations began, they invariably ended on the topic of the upcoming presidential election. Or, more precisely, its potential consequences. But above all: what a second Donald Trump presidency could mean. A topic that caused worried frowns.

Trump's plans are inflationary

When examining the economic policy announcements of candidate Trump, the package as a whole is clearly inflationary. Trump's often impromptu campaign speeches consistently highlight three measures: raising import tariffs, cutting taxes, and the mass deportation of undocumented immigrants – a recipe for driving up prices.

Federal government debt as a multiple of revenues (with trend line)



Source: USTD, OMB, Deutsche Bundesbank, LSEG, LBBW Research

Debt Definition "held by the public", excluding bonds held by public social security systems.

Is the independence of the Federal Reserve at risk?

Naturally, the Federal Reserve (Fed) would have to counteract the inflationary impact of those measures, should they be enacted. In such a scenario, the anticipated interest rate cuts next year would surely be off the table. Even a hike in the policy rate could be envisioned. A President Trump would, of course, take this personally (in his view, everything revolves around him). We remember his first term, during which he regularly criticized Fed Chair Jay Powell for allegedly keeping interest rates too high. Even though he himself had nominated him for the position. In Trump's mind Powell displayed a lack of loyalty – or sycophancy.

A president's persistent nitpicking at an independent central bank is damaging enough. However, a Trump 2.0 presidency could go beyond mere grumbling from the Oval Office. Powell's term ends in early 2026, and the White House has the right to nominate his successor. Some of the rumored names for potential successors give us economists goosebumps – and not in a good way.

While the risk that Trumpists could completely infiltrate the Fed seems moderate – given the institution's federal structure and the fact that the Fed Chair doesn't make decisions alone – the mere discussion of whether a U.S. government could politically undermine the central bank is alarming in itself.

The mere discussion of independence is alarming

The main problem remains the high debt

However, the greater danger would loom from the toxic combination of soaring national debt on the one hand and a Fed that needs to keep interest rates higher to combat inflation on the other. In this situation, the U.S. could quickly slip into what economists call "fiscal dominance": the central bank would, in practice, no longer be free in its decision-making because of the overwhelming national debt. Raising interest rates could then lead to an unsustainable interest burden for the state, ultimately resulting in state bankruptcy. And we're not talking about Greece here! The market for U.S. Treasury bonds is absolutely essential to the functioning of the global financial system. A loss of confidence here could lead to the mother of all financial crises.

Consolidating the U.S. federal budget should, therefore, be a top priority! Unfortunately, neither the Democrats nor the Trumpists have grasped the nettle of this pressing priority. Neither offers a convincing plan of consolidating public finances. Predicting the "point of no return" is difficult, but given Trump's economic policy plans, that tipping point could come sooner than previously feared under his leadership.

No candidate has a convincing budget plan

I wish I had brought back from New York more positive news.