Istituto Affari Internazionali

A Tough Opponent for Trump: Inflation

by Matteo Bursi

According to several pre-election polls, the economy was perceived by many US voters as the key topic in deciding whether to vote Democratic or Republican in the 2024 presidential elections.[1] During Joe Biden's administration, the US GDP grew steadily and unemployment reached very low levels. Nevertheless, for the first time since 2004, the Democratic Party lost the presidency, the popular vote, the House of Representatives and the Senate. This seemingly paradoxical situation, according to some commentators, finds an explanation in the issue of inflation.[2] From this perspective, a significant number of Americans reportedly voted for Donald Trump due to the sharp price increases experienced during the past four years, blaming the outgoing Democratic administration for failing to sufficiently protect the purchasing power of US citizens and businesses.

During and after the election campaign, the tycoon has claimed that he can curb inflation, emphasising his plan to intensify the exploitation of domestic energy resources. This proposal – covered by one of the many executive orders signed by Trump upon taking office – could help contain price increases but is unlikely to be a definitive solution. Likewise, its effectiveness could be largely offset by inflationary pressures arising from other policies that the Republican politician has promised to implement.

[1] See Megan Brenan, "Economy Most Important Issue to 2024 Presidential Election", in *Gallup News*, 9 October 2024, https://news.gallup.com/poll/651719/economy-important-issue-2024-presidential-vote.aspx; and the analysis published by the Pew Research Center on 9 September 2024: "In Tied Presidential Race, Harris and Trump Have Contrasting Strengths, Weaknesses", in *Pew Research Center Reports*, September 2024, https://www.pewresearch.org/?p=186640.

[2] Cfr. David Steinberg, Daniel McDowell and Erdem Aytac, "The Impact of Inflation on Support for Kamala Harris in the 2024 Presidential Election", in *SSRN*, 13 November 2024, https://ssrn.com/abstract=5019711.

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The declining, but stubborn, US inflation

In the post-pandemic phase, after nearly a decade of significant price stability, American inflation began to rise sharply, reaching a peak of 9,1 per cent in June 2022 (year-over-year). Several factors drove this surge. Undoubtedly, as in the European case, the energy sector played a key role, affected by the post-Covid economic recovery and the outbreak of the war in Ukraine. Notably, the months during which general prices soared coincided with significant energy cost increases; similarly, as energy prices fell substantially, overall inflation also began to decline significantly.

However, many analysts believe energy is not the sole driver of this trend. In fact, while US inflation has decreased in recent years, it remains above the Federal Reserve's target (2 per cent annually)[3] and rose to nearly 3 per cent in the last quarter of 2024.[4] According to some economists, this price trend finds two additional causes in the labour market and fiscal policy.[5] In this sense, an unemployment rate slightly above 4 per cent has created conditions for wage increases that drive inflation upwards. At the same time, the persistence of highly expansionary fiscal policies has led to progressive overheating on the demand side, which in turn contributes to rising price levels.

In light of these considerations, in recent months, the Federal Reserve (Fed) has cautiously reduced interest rates – raised by several percentage points during the peak of the inflation crisis – refraining from "promising" significant cuts to the cost of money for 2025.

The costs of Trumpnomics

Donald Trump and his appointed Secretary of Commerce, Howard Lutnick, identified a massive increase in tariffs – far exceeding those implemented between 2017 and 2020 – as a cornerstone of the incoming administration's economic policy. It remains unclear whether these increased taxes on imports will be implemented or merely used as a negotiating tool in international discussions. However, if the tycoon is even partially consistent with his stated intentions, it is reasonable to affirm that a significant tariff hike would create an additional inflationary pressure on

[3] "The Federal Reserve seeks to achieve inflation at the rate of 2 percent over the longer run as measured by the annual change in the price index for personal consumption expenditures." See the Federal Reserve website: *Economy at a Glance - Inflation (PCE)*, last updated on 2 August 2024, https://www.federalreserve.gov/economy-at-a-glance-inflation-pce.htm.

[4] In September 2024, American inflation dropped to 2,4 per cent. Then, it raised progressively in the following months, reaching 2,9 per cent in December. Refer to the US Bureau of Labor Statistics website: *Graphics for Economic News Releases: 12-month percentage change, Consumer Price Index, selected categories*, https://www.bls.gov/charts/consumer-price-index/consumer-price-index-by-category-line-chart.htm.

[5] Consider, for example, Maria Grazia Attinasi and Paola Di Casola, "Post-Pandemic US Inflation: A Tale of Fiscal and Monetary Policy", in *VoxEU*, 17 September 2024, https://cepr.org/node/435128; and Olivier J. Blanchard and Ben S. Bernanke, "What Caused the US Pandemic-Era Inflation?", in *NBER Working Papers*, No. 31417 (June 2023), https://www.nber.org/papers/w31417.

the US economy. Indeed, it is widely accepted among scholars that raising trade barriers and increasing the cost of imported goods inevitably lead to an overall growth in price levels.[6]

At the same time, Donald Trump's previous presidency demonstrated a lack of inclination toward strict budget discipline. In fact, between 2017 and 2020, the federal deficit-to-GDP ratio deteriorated progressively, largely due to the tax cuts outlined by the Republican administration (consider, for example, the Tax Cuts & Jobs Act). Even though the new Secretary of the Treasury, Scott Bessent, has declared his objective of bringing the deficit-to-GDP ratio back to 3 per cent, the tycoon's promises to preserve and strengthen tax cuts suggest that the US budget deficit is unlikely to decrease significantly in the coming months (currently exceeding 6 per cent).[7] This persistent ultra-expansionary economic policy would further heat the demand side and, consequently, further increase inflation. Similarly, the continued expansion of US public debt could logically lead to higher interest payments on Treasuries, exerting additional pressure on the Federal Reserve to intervene with federal bond purchases – which could contribute to the rise of price levels.

The ability of the new US administration to contain inflation will have direct repercussions on Europe. In fact, despite the European Central Bank asserting its independence from the decisions made by the Federal Reserve, it seems unlikely that the ECB would not take into account the dollar-euro exchange rate and the interest rates set by the Fed, given the significant impact of these two variables on the European economy: a consequence of the size of the US GDP and of the still solid dominant international role of the dollar.[8]

The Federal Reserve independence

In this context, the Federal Reserve finds itself in a challenging position. In fact, persistent or possibly increasing inflation would compel the Fed not to lower, or even to raise, interest rates. Such a decision, aimed at cooling the demand side, would impact the economic cycle, in turn affecting the unemployment rate, GDP growth and the exchange rate between the dollar and other currencies (potentially appreciating the US currency to the detriment of exports).

During his first term, Trump showed significant dissatisfaction with the Fed's decisions to raise interest rates, repeatedly attacking Jerome Powell and, more or less explicitly, indicating his disapproval of the central bank's high degree of independence from politics.

[6] On this issue see, among others, Olivier Blanchard, "How Will Trumponomics Work?", in RealTime Economics, 13 November 2024, https://www.piie.com/node/17515.

[7] Regarding the evolution of the American deficit-to-GDP ratio, refer to the Federal Reserve Bank of St. Louis website: *Federal Surplus or Deficit [-] as Percent of Gross Domestic Product*, https://fred.stlouisfed.org/series/FYFSGDA188S.

[8] About this topic refer, among others, to Riccardo Degasperi and Fabrizio Venditti, "US Monetary Policy Spillovers to the Euro Area", in *Questioni di Economia e Finanza*, No. 891 (November 2024), https://www.bancaditalia.it/pubblicazioni/qef/2024-0891/index.html.

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The White House's "annoyance" with the autonomy granted to the Federal Reserve is not a novelty of Trump's presidency: Nixon, for example, placed a close ally (Arthur Burns) at the helm of the Fed, in order to maintain low rates and enhance his re-election prospects; Lyndon Johnson, on the other hand, went so far as to physically push chairman William McChesney Martin against a wall, accusing him of refusing to "print money" during a critical phase of the Vietnam war.[9]

However, Trump, on this issue as on many others, elevated institutional conflict to unprecedented levels. Over the years, the tycoon has systematically and publicly attacked the Federal Reserve's decisions, with several advisers of the 47th President reportedly even considering dismissing Powell prematurely or proposing coordination between the Treasury and the Fed in setting interest rates.[10] However, both these options (which could significantly diminish Fed's independence and undermine its goal of achieving price stability), are highly challenging to implement. The first appears, from a legal standpoint, difficult to pursue and, even if successful, would not necessarily lead to a drastic change in the Federal Reserve's orientation, given that the Federal Open Market Committee (FOMC) – the body making monetary policy decisions – comprises twelve voting members. The second – coordination between the Fed and Treasury to set rates – would require an amendment to the Federal Reserve Act, necessitating a majority in both houses of Congress, which, due to the Senate filibuster and potential opposition from some Republicans, would be hard to achieve.

In this scenario, it is reasonable to expect that Trump will be forced to accept the central bank's continued independence from the executive, resorting to attacking it with loud statements in hopes of influencing some FOMC members. Such a situation might facilitate inflation containment but would undermine the very ambitious economic expansion goals promised by the tycoon.

In search of a complex balance

Over the next four years, Donald Trump will face the challenging task of sustaining economic growth without triggering further inflation. Nevertheless, his electoral promises will be difficult to reconcile with this ambitious goal: without abandoning several of his "commitments", balancing low unemployment, price stability and GDP growth may prove complex. US voters have placed their trust in the tycoon's purported ability to manage the economy better than Biden and Harris. Should results deviate from

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[9] See Burton A. Abrams, "How Richard Nixon Pressured Arthur Burns: Evidence from the Nixon Tapes", in *Journal of Economic Perspectives*, Vol. 20, No. 4 (2006), p. 177-188, https://doi.org/10.1257/jep.20.4.177; and Kevin Granville, "A President at War with his Fed Chief, 5 Decades before Trump", in *The New York Times*, 13 June 2017, https://www.nytimes.com/2017/06/13/business/economy/a-president-at-war-with-his-fed-chief-5-decades-before-trump.html.

[10] Consult Andrew Restuccia, Nick Timiraos and Alex Leary, "Trump Allies Draw Up Plans to Blunt Fed's Independence", in *The Wall Street Journal*, 26 April 2024, https://www.wsj.com/economy/central-banking/trump-allies-federal-reserve-independence-54423c2f.

those promised, it would be logical to expect negative repercussions on the approval ratings for the 47th President – although logic does not always perfectly apply in politics, especially when dealing with someone like Donald Trump.

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