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**Article**

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# Latin American Journal of Central Banking

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## Whither U.S. inflation and interest rates?☆

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### ABSTRACT

I consider a long-term outlook for the U.S. economy. My thesis is that the U.S. has moved from a deflationary regime to an inflationary regime. The shift is associated with China's emergence as a *bona fide* geopolitical rival to the U.S. and what this geopolitical event implies for the supply and demand for U.S. Treasury securities going forward. U.S. fiscal deficits are likely to remain large. The growth in the global demand for U.S. Treasury securities shows signs of slowing. Together, these forces are likely to exert upward pressure on U.S. inflation and interest rates.

### 1. Introduction

In this talk, I discuss a topic that is currently on the minds of many people, especially given the result of the recent U.S. presidential election. I focus on the relationship between inflation and interest rates in the U.S., both in the past and as we look toward the future. I start by providing an account of the COVID-19 pandemic and its aftermath, including the policy responses. Then, I will elaborate on my outlook.

### 2. The COVID-pandemic and policy responses

Changes in the structure of interest rates have significant economic consequences for households, businesses, and governments in the U.S. and around the world. Since the early 1990s, we have lived in an environment characterized by very low interest rates. A related phenomenon, especially since the 2008–09 financial crisis, was the phenomenon of low (below target) inflation. All of this was to change abruptly in 2020.

The COVID pandemic, together with government policy responses and other shocks, shattered our previous low-interest rate, low-inflation environment. In the U.S. and other regions, we have witnessed the aftershocks of the pandemic slump, notably the surge in inflation, which has recently begun to decline, approaching the Federal Reserve's official target of 2 percent (see [Fig. 1](#)). Despite this improvement, considerable anxiety remains regarding future economic conditions, particularly concerning interest rates, which were elevated following the Federal Reserve's policy tightening in 2022.

The pandemic shock was both severe and unusual. It was unusual in the sense that the recession was policy-induced. That is, the economy contracted as part of a deliberate effort to shut down contact-intensive sectors to slow down the spread of the virus — to “flatten the contagion curve”. The pandemic slump markedly differed from the typical demand-driven recession we experienced, for instance, during the global financial crisis of 2008–09. One notable difference was its impact on global supply chains.

Moreover, in many nations, massive fiscal stimulus packages were deployed. In the U.S., there was the CARES Act and the American Rescue Plan (ARP), each amounting to two and a half trillion dollars, around 10 percent of the GDP in 2020 and 2021. Although these programs could have been better designed, overall, they accomplished what was necessary. American households

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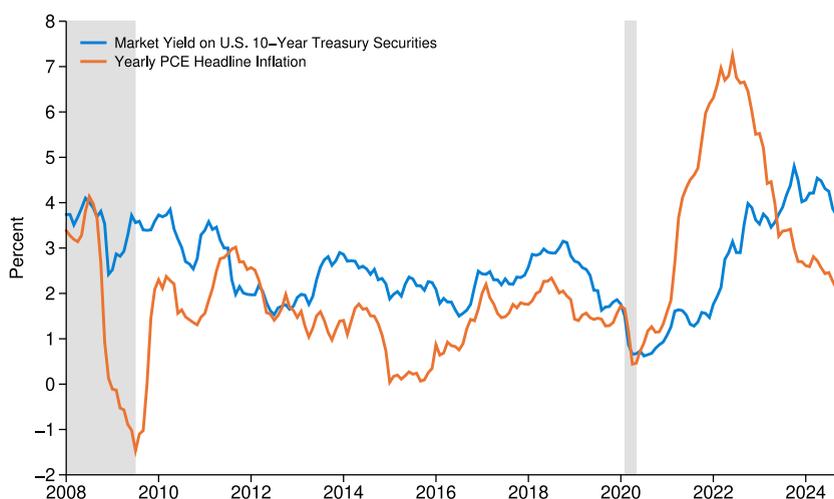


Fig. 1. U.S. PCE Inflation and 10-Year U.S. Treasury Rate.  
Source: Federal Reserve Economic Data (FRED).

and businesses bore the brunt of the self-inflicted crisis disproportionately. The leisure and hospitality sectors, including airlines, casinos, and hotels, were severely impacted, with many establishments forced to close. Both CARES and ARP provided those most afflicted households and businesses with needed economic relief.

Though the Federal Reserve played a valuable role by launching emergency lending facilities to calm the financial markets — many of which were not even taken up, underscoring their signaling function — the cut in interest rates in March 2020 was probably unnecessary. At that time, it was not about stimulating the economy by cutting policy rates but redistributing resources through a better-targeted and more active fiscal policy.<sup>1</sup>

### 3. The outlook

The remainder of this talk is prospective, summarized in the title: Whither U.S. inflation and interest rates? Rather than providing forecasts for the immediate future, I will try to detect tectonic shifts driven by underlying political and economic trends. These trends will permit me to make conditional forecasts that may prove useful in contingency planning.

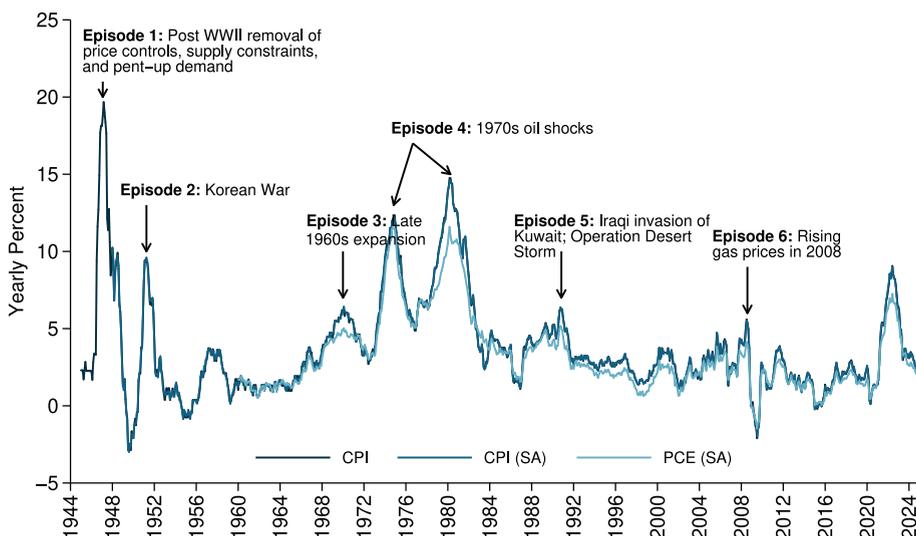
Based on recent history, we know how monetary policy in the U.S. would respond to inflation and unemployment dynamics in the future. As usual, the Federal Reserve will determine interest rates directly through its administered rates or indirectly through open-market operations and forward guidance. Although fiscal regimes are more difficult to predict, historical evidence remains helpful in making conditional predictions. For instance, even if we cannot forecast what sort of new policies might emerge in the future, we can anticipate the likely fiscal policy response when facing the next pandemic.

In a nutshell, my outlook is that the U.S. economy over the long run is likely to run hot, in part because of the trajectory of fiscal policy, and in part because of productivity growth. Fiscal pressures are likely to remain elevated. Consequently, inflationary pressures are likely to remain elevated. The Federal Reserve's two percent inflation target is more likely to serve as a floor than an average around which inflation will be expected to fluctuate. Given the Federal Reserve's mandates, I expect interest rates to remain elevated relative to recent norms as well.

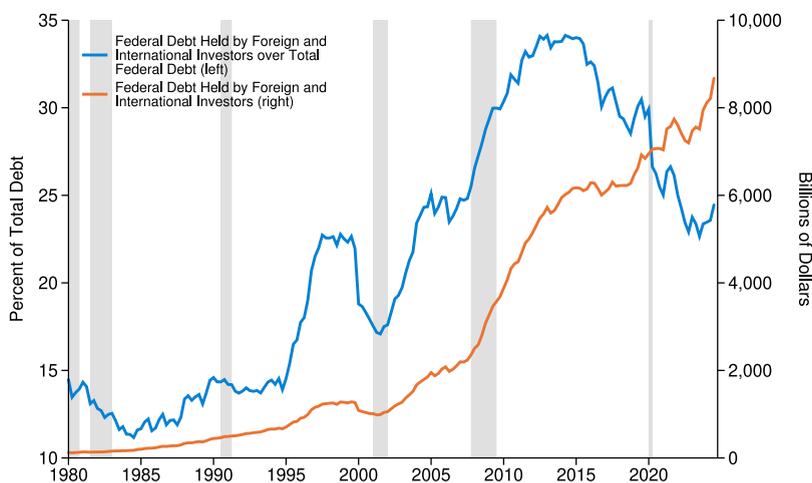
Fig. 2 plots U.S. inflation in the last 80 years. Since WWII, inflation has been relatively low, typically under four or five percent. Scattered inflation spikes are tied to specific events, such as wars and well-known supply shocks. The disinflation in the 1980s is widely attributed to the Federal Reserve and Paul Volcker, who raised interest rates to 20 percent. The fact that the Federal Reserve can tame inflation at the expense of causing a recession is evident. The key question, however, is what kept inflation down after that? It was not high interest rates that accomplished the so-called Great Moderation. Monetary policy cannot unilaterally bring inflation down in the long term. The disinflation was more likely attributable to adjustments in fiscal policy and the growing global demand for U.S. Treasuries, together with the growth of the U.S. economy.

Most people view the U.S. national debt as a financial burden. But U.S. Treasury securities may be better thought of as a form of wholesale money that greases the wheels of the global financial system. The demand for U.S. Treasury securities, particularly in the U.S., is of immense importance and cannot be overlooked when contemplating the path for interest rates and inflation. There

<sup>1</sup> In a recent paper, [Andolfatto and Martin \(2025\)](#) lay out an interpretation of the current situation and past emergency crises. Inflation (tax) is a constrained and efficient way to finance emergency expenditures for redistributive purposes. The model also suggests that, in the aftermath of the pandemic, the inflation surge would have been transitory even without the Federal Reserve's tightening. In this scenario, transfers, acting as a helicopter drop of money, and transitory supply shocks, would eventually dissipate.



**Fig. 2.** Inflationary Shocks: Wars, OPEC, Pandemics.  
 Source: Federal Reserve Economic Data (FRED), Haver Analytics, CEA calculations.



**Fig. 3.** Foreign Demand for U.S. Treasury Securities.  
 Source: Federal Reserve Economic Data (FRED).

have been several forces in place that have driven the demand for U.S. Treasury debt. First, the proliferation of shadow banking in the 1970s and the use of U.S. Treasury collateral in the repo and credit derivative markets have contributed to the rising appetite for these securities, underscoring their significant role in the international financial system. Next, the global financial crisis has had a profound impact on the demand for U.S. Treasuries as a substitute for private-label safe assets that were wiped in 2008–09. This, coupled with China and other emerging economies’ massive appetite for these securities, the European sovereign debt crisis, and then the additional demand generated by regulatory reforms like Basel III and the Dodd-Frank Act, which prohibited the rehypothecation of the U.S. Treasuries, all significantly increased the demand for U.S. Treasuries in the past decades.

Geopolitical considerations are also part of the equation. The collapse of the Soviet Union in the early 1990s led to the U.S. becoming the sole global superpower. Another key factor is China’s entry into the WTO and its role as a net lender in international markets. Finally, the Federal Reserve opened its repo facilities both domestically and for foreign actors, allowing domestic and foreign holdings of U.S. Treasury securities to be monetized on demand.

The U.S. has benefited from these deflationary forces. In Fig. 3, I plot the foreign demand for U.S. Treasury securities in the orange line, the absolute quantity as measured on the right axis, which is currently 8 trillion dollars, and the blue line representing the fraction of U.S. Treasury securities held by foreigners. The massive increase in the demand for these securities is evident. To further make the case, I plot the debt-to-GDP ratio in Fig. 4. While a rising ratio may concern some people, I view the phenomenon

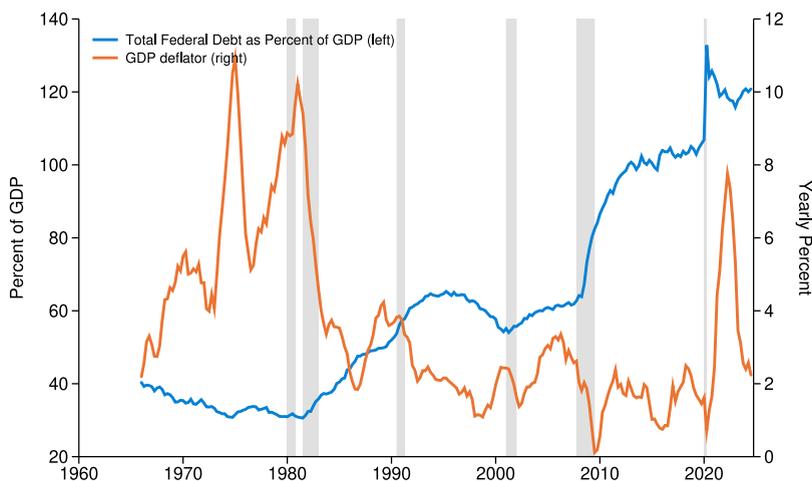


Fig. 4. Debt-to-GDP Ratio Measures the ‘Demand’ for Debt.  
 Source: Federal Reserve Economic Data (FRED).

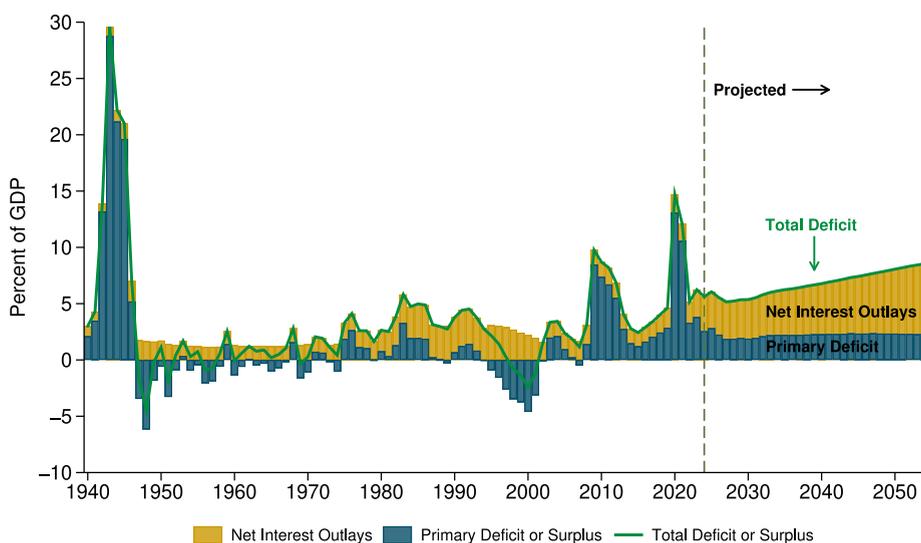


Fig. 5. Projected U.S. Deficits.  
 Source: CBO Long-Term Budget Outlooks: 2024 to 2054. Data as of March 2024.

somewhat differently. If Treasury securities serve as a form of money or collateral asset, then a higher debt-to-GDP ratio can be interpreted as a sign of strength instead of weakness. That is, no one wants to hold the debt of a weak nation.

Theoretically, the debt-to-GDP ratio measures the real demand for Treasury securities. This demand declined during the 1970s, a period that coincided with rising inflation. The opposite also held when low inflation occurred along with a buoyant demand for U.S. Treasuries since the early 1990s. Recently, the high inflation we experienced after the pandemic has been consistent with the debt-to-GDP ratio coming down. The worry is not that the debt-to-GDP ratio is high or that the U.S. will default on its debt. The concern is that the debt-to-GDP ratio will decline rapidly — not through real economic growth — but through a rapid increase in the price level (which serves to increase the nominal GDP — the denominator in the debt-to-GDP ratio).

The key game changer is China, which is establishing itself as a new geopolitical rival to the U.S. The demand for massive expenditures, particularly in the military and domestic infrastructure, combined with a reluctance to raise taxes in the U.S., may leave “printing money” as the only viable option to finance the looming increase in federal debt amid new geopolitical pressures.

The role of U.S. productivity growth in accommodating these additional fiscal demands should not be discounted. But if U.S. productivity growth will not save the day, then the situation as described by the CBO projections for the next 30 years in Fig. 5 is unsustainable. In summary, my outlook involves relying on government paper to finance a growing debt in a divided and fragmented

world with latent political and economic rivalries. As part of a reassessment of political and economic power, we can expect to see high interest rates and inflation.

#### **4. Concluding remarks**

Political and economic tectonic forces, ultimately reflected in the tug-of-war between supply and demand for U.S. Treasury securities, point to inflationary pressures that will likely manifest as inflation, higher interest rates, or both. The U.S. has significantly benefited from disinflationary forces from 1990 until recently. I think it is wishful thinking to expect these forces to continue unabated. The prospect of an escalating Cold War with China is a genuine concern, underscoring the importance of developing contingency plans.

#### **Declaration of competing interest**

None interests declared.

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