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The Federal Reserve's antigrowth assumptions undercut the dollar and hinder affordability.

The Answer to Trump's Good Question About Interest Rates

By David Malpass

In his Davos speech last week, President Trump asked why the interest rate is so much higher on U.S. Treasury debt than on bonds of weaker countries. Good question. The U.S. economy is strong, and the default risk low, so why the higher yield? For 10-year debt, we pay 4.2%. Japan pays 2.3%, China 1.8% and Switzerland 0.3%. Applied to the nearly \$38 trillion of U.S. national debt, that's a staggering extra cost.

One reason for high long-term rates is the still-high short-term interest rate. The Federal Reserve sets the short-term rate, but its models use backward-looking inflation data and treat growth as inflationary, leaving rates too high.

But cutting short-term rates without reforming the Fed's economic models risks higher long-term rates and a selloff in the dollar. After the Fed cut rates by 0.5 percentage point in September 2024, long-term yields went up by 0.5 point, not down. Markets were aghast at the political timing of the rate cut.

Sweeping reforms in the Fed's economic models to defend the dollar offer a straightforward path to lower interest rates across the yield curve—short-term and long-term. The Fed's models ignore the effects of dollar weakness on inflation and interest rates and treat faster growth as a cause of inflation. Already many at the Fed argue that U.S. growth is too fast and unemployment too low for the Fed to cut rates.

In Davos, the president trashed this illogic. If a country is doing well, why is it bad news for financial markets, and why does the Fed set its rate higher, not lower? Sound money and a stable dollar are at the core of the supply-side model of booming economic growth, along with the Laffer Curve's proof of lower tax rates and Milton Friedman's defense of free markets.

While the Fed wants to focus attention on its independence, which isn't at risk, the problem is that the Fed's antigrowth models undercut the dollar and keep interest rates and bond yields high. This can be corrected in short order by defending the dollar and inviting huge new investment into U.S. financial markets, including Treasurys.

The Fed's models have failed repeatedly in the central bank's primary task of fostering price stability and full employment. The models don't take into account changes in supply-side growth policies or the value of the dollar. The result is that interest rates are set too high during supply-side growth and disinflation and too low during false demand-side growth as occurred in the Biden administration's government spending blowout.

Until sweeping reforms are implemented, the Fed may stick stubbornly to high interest rates to fight Mr. Trump's growth program. The Fed's monetary policy models—backward-looking inflation targeting, the Phillips Curve, nonaccelerating rate of unemployment, limits to growth, the output gap, potential gross domestic product—take direct aim at supply-side policies to boost energy production, cut tax rates and improve regulation. The models set a ceiling on the growth rate and a floor on the unemployment rate.

The Fed's regulatory framework fails by having the government, not markets, assess risk. And the Fed's quantitative-easing strategy causes it to buy trillions in government bonds, which works directly against affordability, as Treasury Secretary Scott Bessent pointed out on these pages in September. The Fed's holding Treasury bonds was one of the big mistakes of the Obama and Biden administrations because it caused income inequality and hurt affordability. It helps big government, big business and the wealthy increase their demand at the expense of job creation and real wages.

Why is defending the dollar so important? Investors look for total return. For bonds, total return includes interest payments, repayment of principal and, importantly, the exchange rate. The appreciation of the Swiss franc, for instance,

has been worth much more than the higher U.S. bond yield.

Also important, dollar weakness benefits China. China sold U.S. Treasurys in favor of gold, enjoying a huge return as the dollar weakened. It is already one of the world's biggest producers of silver, which has soared during dollar weakness. China has induced Kenya and Ethiopia, with more to come, to convert their dollar debt into yuan debt. China is creating added liquidity in its yuan debt markets by offering the Japanese-style carry trade in which companies and countries can borrow in yuan to get lower yields and diversify their liabilities.

Even so, a stable-dollar policy would face opposition from the economics community—the “eggheads,” as Mr. Trump calls them. The value of the dollar is excluded from the Fed's inflation models, and all signs are that the Fed is entrenching these models and Trump-proofing them to fight growth.

After its Dec. 10 meeting, the Fed self-appointed 23 senior officials—11 of the 19 members of the interestrate setting Federal Open Market Committee and all 12 first vice presidents of the regional Federal Reserve banks. Unless the Fed adopts sweeping policy reforms, the FOMC is likely to fight growth with high rates, particularly as the midterm election comes into view.

The Fed also announced a QEtype expansion of its balance sheet. The Fed is now imposing that affordability burden on the Trump administration.

U.S. bond yields and mortgage rates could be substantially lower if U.S. policy defended the dollar and strengthened market confidence and trust. This path is easily available to Mr. Trump by stating that his administration wants the dollar to be stable, not weak. This would cause more global investment in dollar-denominated assets, including dollar stablecoins, an economic home run. It would also reverse the Biden administration's weakness, a political home run. And it would allow markets to help the Fed decide to lower the shortterm rate.

Mr. Malpass served as an undersecretary of the Treasury (2017-19) and president of the World Bank (2019-23).

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