

From Dropping Bombs to Dropping Bonds

di Paul Krugman

10-year interest rate



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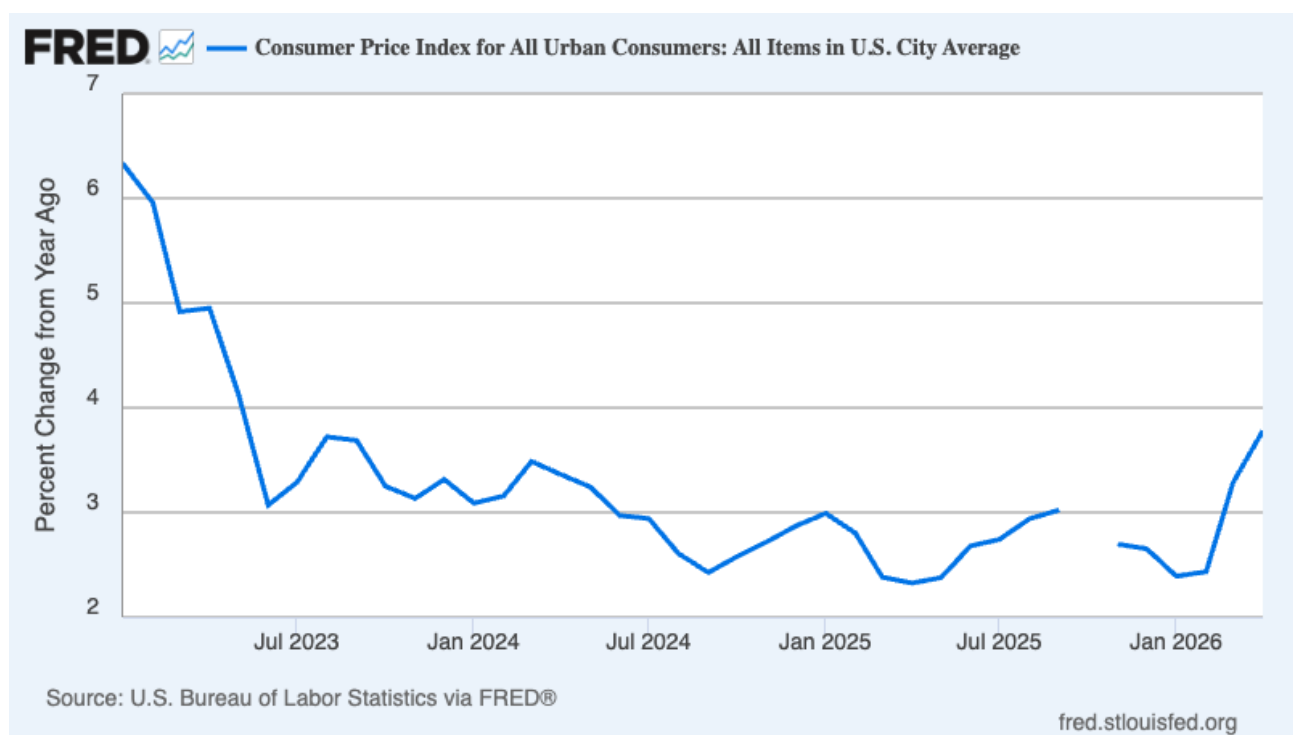
Busy day, so just a note on the latest bad news.

This morning's economic headlines are largely about spiking interest rates. "The global bound rout is accelerating," says the [Wall Street Journal](#). "Bond yields hit highest level since 2007 as inflation fears set in," writes the [New York Times](#). (Falling bond prices mean higher interest rates.)

There's some hyperbole in these headlines. It's true that the 30-year interest rate is at an almost 20-year high. But economists usually focus on a different long-term interest rate, the rate on 10-year bonds. And while that rate is up sharply since the Iran War began, it's only roughly as high now as it was when Donald Trump took office, and below its recent peak in 2023.

Still, why are rates spiking, and what does their rise portend?

Interest rates are up because inflation, which was declining until Trump returned to the throne, has surged again:



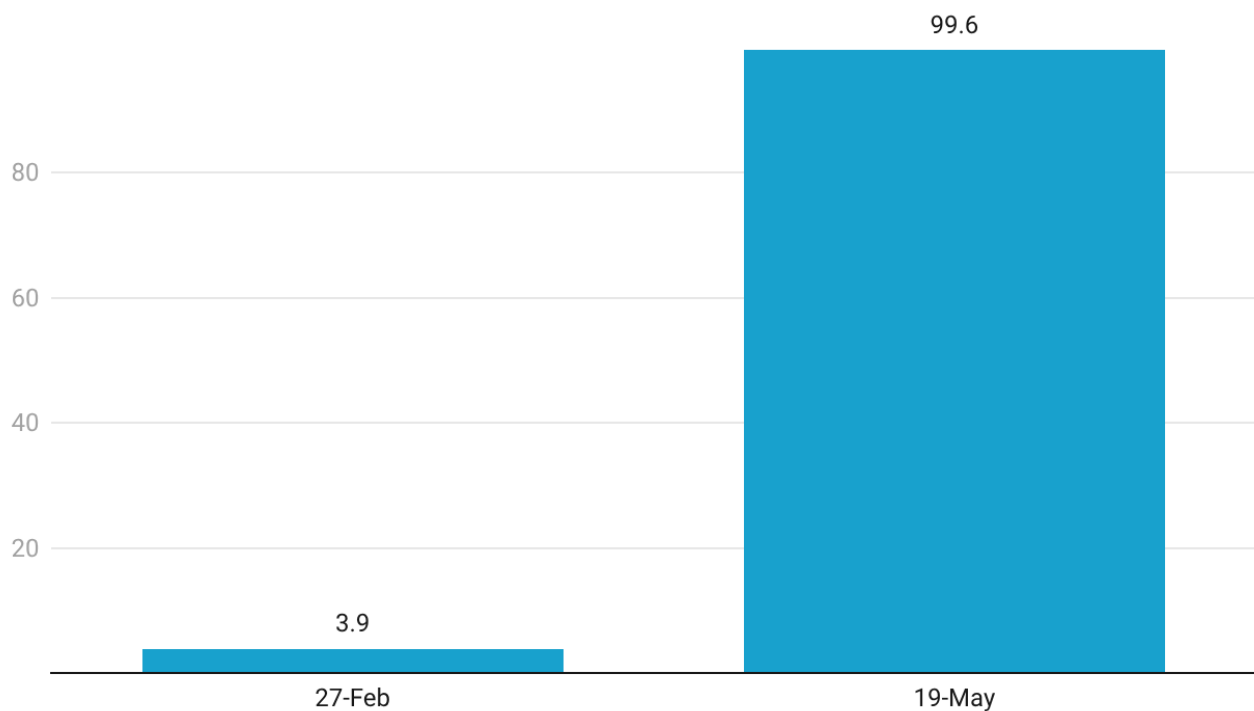
Investors are responding to the fact that the current rise in inflation looks a lot like the rise in inflation during 2021-2023, which was the result of supply chain disruptions. Back then the Federal Reserve was compelled to raise short-term interest rates to curb inflation. Longer-term interest rates, which largely reflect expected future short-term rates, followed suit.

Now we're seeing a remake of that movie, with one big plot difference. The inflation spike of 2021-22 was overwhelmingly the result of factors outside Joe Biden's control — surging demand as the world recovered from Covid and Vladimir Putin's invasion

of Ukraine. The current inflation surge, by contrast, is all Trump, caused by his self-defeating tariffs and the gratuitous debacle in Iran. And the inflation outlook is worsening by the day as the Strait of Hormuz, through which about 20 percent of the world's supply of oil normally passes, remains closed.

Until now, markets have been complacent about the implications of the Iran war. Investors have allowed themselves to be lulled by Trump's repeated assurances that either victory or a negotiated settlement were just around the corner. But they are now waking up to the reality of the debacle. And their awakening has transformed expectations about future monetary policy. On the eve of the bombing, markets were virtually certain that the Fed would cut short-term rates by December. Now they're virtually certain that rates will either rise or at best stay the same:

Market-implied probability that rates will stay the same or rise by December

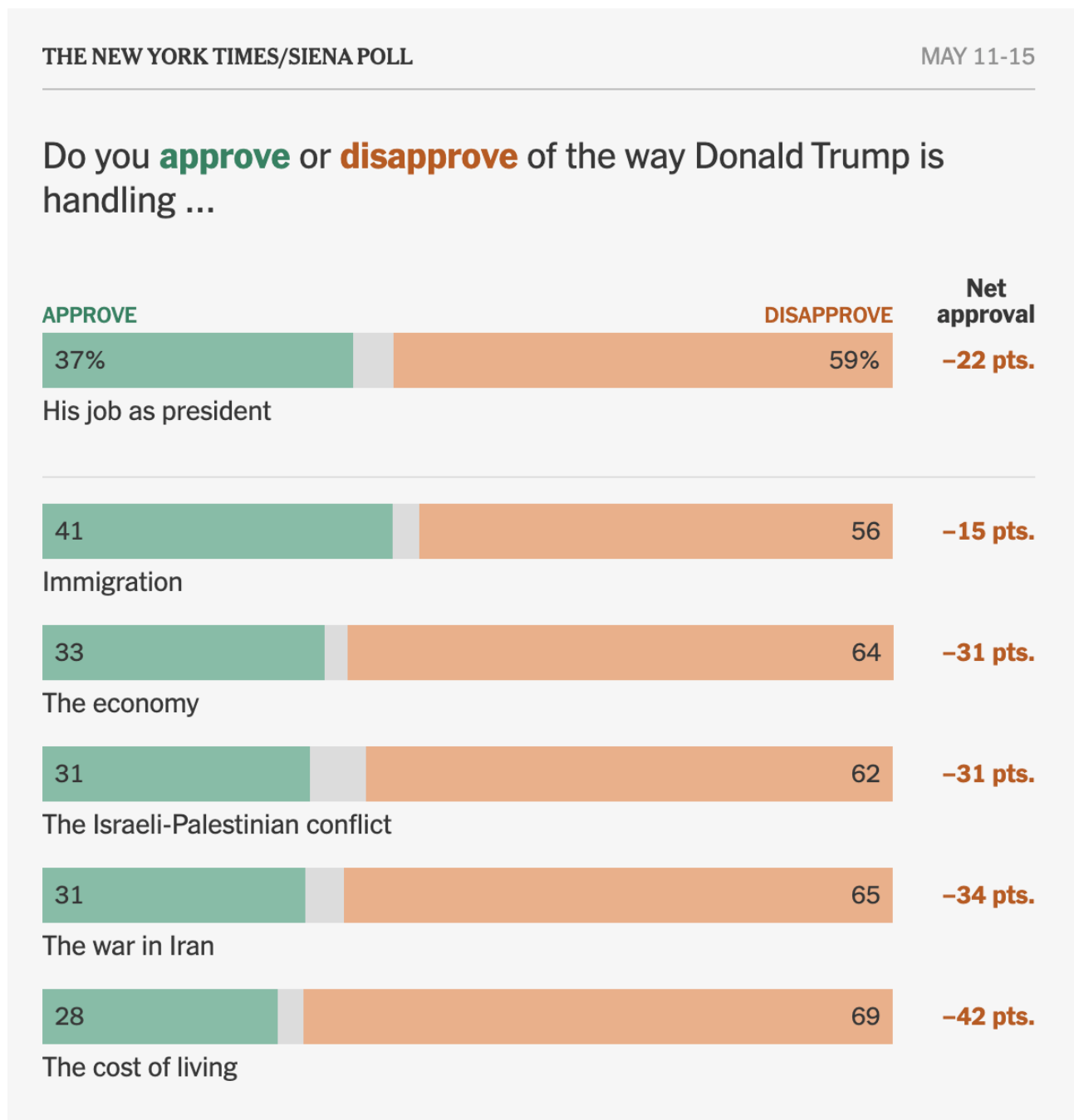


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Moreover, the market will be watching closely to see how Kevin Warsh, Trump's new Fed chair, responds to this new reality.

Warsh's job, as Trump sees it, is to support him politically by cutting interest rates, regardless of the economic evidence. Warsh will surely face especially intense pressure from his patron to deliver lower rates because rising interest rates will deepen Americans' anger over Trump's management of the economy. Surging gas and grocery prices have already caused Trump's economic approval to crater:



Now the pain will be greatly intensified by soaring interest rates on mortgages, car loans, and more. And rising rates tilt the economy toward a slowdown, possibly even a recession. So I'm sure we'll see many ALL CAPS posts from Trump demanding drastic interest rate cuts NOW NOW NOW.

But what the markets are telling us is that in the face of rising inflation, they strongly expect that most members of the Fed's monetary committee will vote either to raise rates or at best to leave them unchanged. So will Warsh start his tenure by being repeatedly outvoted, rapidly losing credibility within the institution he's supposed to run? Or will he, as Trump will surely see it, betray his master? All I can say to Kevin Warsh is, "just deserts."

One thing is clear: The markets are finally waking up. And the economic and political fallout from Trump's decision to emulate his idol Putin by launching what he believed would be a short, victorious war is just getting started.