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The Challenge for Kevin Warsh – August 2026

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We do not know the new Federal Reserve Chair but know several people who do, and all agree on two things. First, he is very clever. Second, his curiosity and intellectual confidence mean he is prepared to engage with difficult questions even if this process yields unconventional answers.

His early comments have been somewhat vague and emphasising the need for external expertise to help with strategic goals. Our suspicion is this reflects a recognition on his part that the conventional approach (and commentary) on the role of central banks faces significant intellectual challenges in the modern economy.

The conventional view that we think is being challenged can probably be summarised as follows.

Through management of short-term interest rates, the Fed determines monetary conditions. This is done in a balanced way, with higher rates required when inflation is the major risk and reduced when fears of unemployment are more pressing.

Three flaws in this seem to us now evident, each of which we suspect is on Kevin Warsh's mind but is hard to discuss openly for a range of reasons (impact of discussion itself, politics being the two largest ones).

1. Short-term Interest Rates Are a Partial Control of Monetary Conditions

Fed Chair Warsh's comment that rises in long-term bond yields had tightened conditions was both accurate and fascinating in its implications. It reflects two factors in the modern economy, both of which are very different from prior periods. First, most discretionary funding is based on long-term interest-rates or the cost of equity (AI capex) rather than short-term interest rates. Second, with the private sector so liquid the effect on incomes from higher short-term rates is very different from periods when it was more indebted. The UK has seen this pretty evidently in the last few years, with rate rises actually a net positive given the lack of leverage in the consumer sector.

The implications of this are fascinating, not least because they are the opposite of how the market currently interprets Fed decision-making. Long-term rates rising because of the expectations of Fed policy actually make it less necessary for the Fed to tighten. Conversely, should not raising rates cause investors to worry more about long-term risks, the possibility is an easing measure may actually tighten financial conditions.

2. The Supply side is Dominating Inflationary Expectations

Orthodox monetary policy largely ignores the supply-side, arguing that changes in interest-rates move demand and adjust inflation accordingly.

This has worked reasonably well historically but arguably is the opposite of what looks likely this decade. In the short-term supply disruptions (energy and memory) are the main drivers of higher inflation. In the long-term, AI is generally expected to be a major deflationary driver, especially for demand for labour.

This presents two challenges to Warsh. First, having a view on the durability of supply shocks in either direction surely becomes the major influence on structural policy shifts. This would be difficult at any time, but particularly so when immediate drivers pull in opposite directions at different speeds.

Secondly, should one accept the premise that supply is the major driver of inflation, the policy response may well be unorthodox. At some level, supply shortages are best met by more investment, implying lower interest-rates rather than higher as the monetary medicine.

3. Impact of Short Rates on the Relative Cost of Capital

We noted above that overall monetary conditions are much more widely set than simply Fed decisions on short-term rates. Alongside the challenge for an independent central bank controlling only part of the funding structure, this also means that Fed policy almost certainly impacts relative funding conditions as well as absolute.

Two illustrations of this are particularly relevant in our view. First, monetary policy post-GFC (alongside bank regulation) essentially skewed funding costs in favour of governments versus the private sector. This, for us, is why productivity subsequently fell (and was therefore bad economic policy) but it also had distributional consequences (age as well as wealth-driven) that are surely political.

Currently, we have a very low marginal funding cost for AI build-out that, at some level, is creating a reaction in borrowing costs at the expense of governments and homebuyers. Again, one can argue economically what is optimal, but the political consequences of this are real.

Conclusion

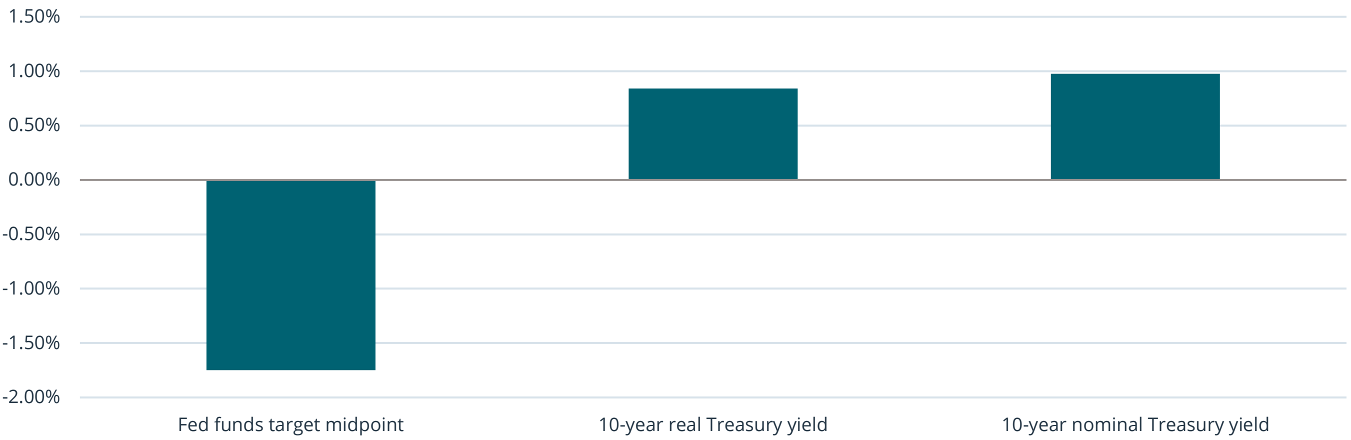
We feel each of the above would individually challenge any Fed Chair. Where it gets particularly interesting is the reality that such challenges will interact in any actual policy decision. Most importantly, if, as we suspect, Warsh believes private sector investment is the best route to low inflation and low unemployment, three challenges remain unclear to us.

- Given the partial effect of short-term rates and these interdependencies, what is the optimal policy path to achieve this?
- How does one explain such a view to a market stuck in a demand-driven narrative and a febrile political environment?
- Monetary policy alone will have finite impact on this goal, with fiscal and regulatory policy at least as important. Given this interaction, is the notion of an independent central bank credible or important?

We neither know the answers to the above, nor whether this really is the direction of travel of Warsh thinking. We look forward to any thoughts from readers and further utterances from the Fed Chair to see whether our suspicion that these are the right questions is at least partially correct.

The Fed Has Cut Rates, but Long-Term Treasury Yields Have Risen

Change since 17 September 2024, basis points



Source: Bloomberg. Data as at 06/08/2026