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Look past the interest-rate forecasts and you'll see a major rethinking under way at the central bank.



Kevin Warsh at the Jackson Hole conference. DAVID PAUL MORRIS/ BLOOMBERG

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Fed policies

Warsh's New Principles for the Fed

By Mickey D. Levy

Fed Chairman Kevin Warsh's recent Jackson Hole speech laid out the principles he hopes will steer the Federal Reserve toward a new way of thinking about its dual mandate of high employment and low inflation. But news reports largely ignored these principles, and financial markets focused on what his speech suggested for interest rates at the Fed's September meeting. Mr. Warsh's principles deserve more attention. They challenge certain thought processes and approaches that have become ingrained at the Fed, including some that have led to major policy mistakes.

Mr. Warsh said the Fed's role is to manage aggregate demand and align it with supply. "I do not believe," he stated, "the Fed's dual mandate works at cross-purposes." On forward guidance, Mr. Warsh said that "wage growth has not proven a reliable indicator of future inflation." He discussed the benefits of a reaction function, such as the Taylor Rule, that would systematically guide monetary policy and inform the public, but said "our knowledge just doesn't extend that far." Another Warsh principle: "Money matters. . . . We should pay attention to money created by the central bank and money that comes from the banking and financial systems."

These statements are logical but at odds with Fed orthodoxy. Mr. Warsh hopes to use his new task forces to influence the Fed's thinking and processes around these issues.

At the heart of the Fed's macroeconomic model and thinking is the view that inflation is driven by wage- and price-setting behavior that is a function of labor-market tightness and inflationary expectations. The Fed pays much less attention to aggregate demand and nominal gross domestic product, which is the broadest measure of current dollar spending.

While the Fed agrees there is no long-run trade-off between inflation and unemployment, historically its focus has bounced from one to the other as if they are in conflict. The Fed has long responded more decisively to perceived weakness in employment than to higher inflation. And for decades the Fed has focused on setting interest rates while ignoring money supply, even in 2020-21 when the M2 money supply rose 40% in response to the Covid pandemic.

History shows that labor-market tightness and the unemployment rate aren't a reliable predictor of inflation, yet the Fed continues to base policy on the Keynesian recipe implied by the Phillips curve, which posits a trade-off between the unemployment rate and inflation.

Bouncing from objective to objective has involved excessive efforts to manage the real economy. In late 2025, the Fed eased rates in response to a string of flat employment reports, even though inflation exceeded its 2% target. Employment reaccelerated

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in 2026, and the Fed now faces the possible need to reverse those fine-tuning rate cuts. But Mr. Warsh is emphasizing that employment and inflation objectives are complements and maximum employment is best achieved through stable, low inflation. Both are best achieved by monetary policy that generates growth in aggregate demand consistent with stable low inflation and real economic growth.

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This implies less bouncing from one objective to the other. It rejects the asymmetric approach of making employment a higher priority than inflation, which historically has translated into letting the economy run hot until labor markets tighten to the point where wages push inflation. This strategy is bound to fail.

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Money supply deserves attention, Mr. Warsh says, even though financial innovations and other factors affect the speed at which currency changes hands. But the Fed's use of interest rates to steer the economy and labor markets can be unreliable. The rate that would achieve the Fed's dual mandate is unknown, interest rates fluctuate with economic performance, and inflationary expectations aren't observable.

How, then, to infuse the Warsh principles into Fed policy and the way its staff thinks? I propose a checklist of three principles for the Fed to consider and debate at every policy meeting: *Note*
1) How fast is nominal GDP growing, and is it consistent with 2% inflation and potential real growth? Its current pace of 6.5% is probably too fast. 2) What is the Taylor Rule estimate of the interest rate and is it far from the current fed-funds rate and the Fed members' estimates, as during Covid? *Note*
3) Is M2 growth reasonable, or is the money stock falling or surging and signaling an undesirable shift in aggregate demand, as during 2020-21? Mr. Warsh's task forces can add to this list.

We all benefit from the Fed's achieving its dual mandate and avoiding major mistakes. Mr. Warsh's thoughtful principles could enhance the Fed's policy deliberations.

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