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Warsh Has Three Big Tasks Ahead

CAPITAL ACCOUNT

By Greg Ip

Kevin Warsh has spent much of the past 15 years criticizing the Federal Reserve for getting too big, mismanaging inflation and compromising its independence.

So as President Trump's pick to succeed Jerome Powell as central bank chair, what does he do about it? He faces three key tests. First, significantly shrink the Fed's balance sheet without upsetting markets. Second, push inflation down to 2% and keep it there. Third, do this without meddling by Trump that compromises Fed independence. All will be tougher than they look.

Fed downsizing

As a Fed governor, Warsh worked with then-chair Ben Bernanke to manage the global financial crisis. He quit over Bernanke's use of "quantitative easing," the purchase of trillions of dollars of bonds, paid for by issuing reserves to banks. Between 2008 and 2022, Fed assets grew from \$900 billion to \$9 trillion. They've since declined to \$6.6 trillion.

Quantitative easing was intended to hold down longterm rates after the financial crisis—and later, after Covid—and to ensure banks had enough reserves to fund themselves and keep markets functioning. Warsh, however, blames Fed bondbuying for encouraging the federal government to run steep deficits, suppressing market signals and ultimately unleashing inflation.

"Each time the Fed jumps into action, the more it expands its size and scope," he said last April. "More debt is accumulated…more capital is misallocated…more institutional lines are crossed."

The Fed, he argues, needs to leave a smaller footprint in the economy. Treasury Secretary Scott Bessent, who led the search for the Fed chair, agrees. Last year he accused the Fed of "mission creep" and "institutional bloat."

Bessent and Warsh, who have both worked for famed investor Stanley Druckenmiller, could end up reorganizing the responsibilities of the Treasury and Fed, giving Treasury a more active role in managing long-term interest rates.

There would be two problems with this plan. Banks now count on ample reserves to fund themselves. A smaller balance sheet that shrinks that supply could upset markets. That's why the Fed stopped shrinking its balance sheet in late 2025.

Second, as the Fed sheds bondholdings, bond yields might go up, pushing mortgage rates higher. That would anger Trump.

Theory of inflation

Warsh's nomination comes with underlying inflation close to 3%, above the Fed's 2% target. He must now articulate a credible plan for getting it down and persuading the Federal Open Market Committee to agree.

Warsh's background is law and finance, not economics. So was Powell's, but he soon adopted the economic framework of the Fed's professional staff. The framework sees inflation as mostly a function of economic slack— the gap between demand and what the economy can supply— as revealed by indicators such as unemployment; as well as the public's inflation expectations.

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Warsh regularly disparages such models and the "economics guild" that developed them. His own explanations for inflation are eclectic, at times drawing on commodity and stock prices, the money supply, productivity and federal spending.

Some fear Warsh's disdain for mainstream macroeconomics could lead to internal upheaval, pitting him against the Fed's professional staff and other FOMC members. Warsh has intimated as much. "What we need is regime change at the Fed, and that's not just about the chairman, it's about a range of people," he said last July. "It's about breaking some heads."

Former Fed Vice Chair Don Kohn, who worked with Warsh under Bernanke and is now at the Brookings Institution, said he disagreed with some of Warsh's criticisms and agreed with others— but not "the caustic tone with which they have been delivered."

Others think he will be more open-minded and conciliatory than his rhetoric suggests. "He's not going to be a passive recipient of information, but he recognizes there's real expertise and experience among the Fed staff he could draw on," said Nellie Liang, who as a Fed staff economist worked closely with Warsh during the financial crisis and is now at Brookings.

Warsh is masterful at managing internal politics and reading people. To deliver a "revolution" in Fed governance requires people skills to bring along the FOMC, said Emil Henry, who worked with Warsh under President George W. Bush and now heads private-equity firm Tiger Infrastructure Partners. "Warsh brings epic high IQ and EQ to the Fed," Henry said.

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Warsh is lucky in that ebbing pressure from tariffs and housing should nudge inflation lower in 2026. But at some point, the pressures nudging inflation lower will change direction. Warsh needs a persuasive theory of inflation to deal with such pressures—one that passes muster with markets and his colleagues.

Saying no to Trump

Many on Wall Street backed Warsh, thinking he would be more independent than the runner-up, White House adviser Kevin Hassett.

Yet he is being appointed by a president who doesn't believe in Fed independence. Trump made pledging to slash interest rates a condition for his Fed chair nominee. Warsh obliged.

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Even Trump acknowledges that if inflation rises, so must interest rates. The tough part of monetary policy is anticipating where inflation will go and adjusting rates accordingly. If data says the Fed shouldn't cut rates, will Warsh defy Trump?

Many on Wall Street suspect Warsh said what was needed to get the job, and after a suitable interval in office, will be his own man.

Warsh's political skills might help him manage the mercurial president. But Trump isn't likely to sit by if Warsh disappoints him.

Independence can also be undermined from within. If Warsh sees himself as part of Team Trump, he might shade his decisions to support Trump's broader agenda.

To be sure, there are still guardrails around Fed independence. The Supreme Court appears ready to restrict Trump's ability to remove governors, including the chair.

But Trump can still make Warsh's life miserable by publicly attacking him and appointing more pliable governors.

At a panel I moderated last year, Warsh acknowledged the importance of independence. Then he added: "I read breathlessly in the newspapers how mean these politicians are to the central bank. Well, grow up. Be tough. What is the secret to central bank independence? Hitting its objectives, doing its job."