Kevin Warsh and US Federal Reserve 'Regime Change'

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- Mr. Kevin Warsh's nomination to be the next US Federal Reserve Chairman could usher in the most sweeping non-crisis era changes to the Fed's operations since 1994, when interest rate decisions first began to be publicly announced.
- Even partial realization of his proposed "regime change" agenda could materially alter how the Fed influences the economy and financial markets.
- Mr. Warsh has articulated the importance of regime change at the Fed, with the potential to reshape policymaking over time. It is our judgment that he intends to pursue dramatic changes should he become the Chairman.
- He is widely characterized as an inflation hawk, based on his tenure as a Fed Governor from 2006 to 2011, though some critics argue his recent openness to easier policy reflects self-interested positioning.
- Market perceptions of Mr. Warsh as an inflation hawk triggered outsized declines in assets linked to "sell America" positioning, with gold and silver prices falling sharply on the day of the announcement of his nomination. Markets appear to view him as unlikely to rubber-stamp significantly lower rates, suggesting near-term policy credibility.
- Short-term market reactions are likely to pale in significance relative to the forward-looking regime change agenda he has outlined in speeches and public writings.
- Under a Chairman Warsh, the influence of US Fed staff is likely to decline meaningfully, with less reliance on mechanical, model-driven forecasts and a reduced "watch the data" approach. This reflects criticism that excessive backward-looking analysis left the Fed late to the 2021–23 inflation surge.
- Mr. Warsh's desire to shrink the US Fed's balance sheet is well known, alongside persistent criticism that its enlarged size has contributed to capital misallocation and central bank intervention into fiscal areas. Despite the runoff, the balance sheet remains far larger than its pre-GFC footprint.
- Meaningful balance sheet reduction would require formal processes and careful management of funding markets that currently rely on the Fed's footprint.
- Successful balance sheet shrinkage would also likely require substantial deregulation and potentially lower policy rates to offset tightening effects.
- Overall, Kevin Warsh's nomination introduces significant uncertainty over how the Fed will influence the economy and financial markets. While structural changes are unlikely to be instantaneous, his agenda is expected to reshape the post-GFC US Fed–market relationship, a transition historically associated with missteps and elevated volatility.

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Kevin Warsh and Fed 'Regime Change'

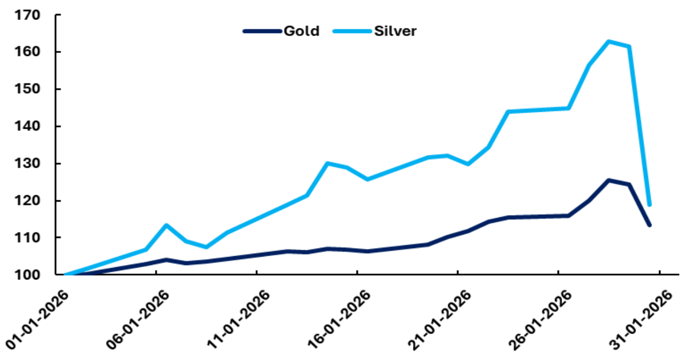
Kevin Warsh's nomination to be the next US Federal Reserve Chairman is likely to usher in the most sweeping non-crisis era changes to the Fed's operations since 1994 when the US Fed first began announcing publicly its interest rate decisions. Mr. Warsh in public comments has been articulating the importance of and need for "regime change" at the US Fed – something that will not happen instantaneously should he be confirmed as the Chairman but that, if even only partially realized, has the capacity to alter broadly how the Fed has been influencing the economy and financial markets for the past nearly two decades.

The knee-jerk characterization of Mr. Warsh – owing in good part from his time as a Fed Governor from 2006 to 2011 – is that he is an "inflation hawk." A less favourable characterization is that he historically has been an inflation hawk and now for self-interested reasons – i.e. to be nominated by the US President Trump as the Fed Chairman – has embraced views in support of easier monetary policy, despite prevailing US inflation rates.

His views on the inflation outlook while a Fed Governor ranged from incorrect (focused on inflation risks in late 2006 when the housing bust already had begun) to wildly incorrect (September 2008, Spring 2009). On the other hand, he was correct in warning about the post-COVID inflationary threat, which neither the Fed nor most ex-Fed officials saw coming.

The perception of financial markets that Mr. Warsh is an inflation hawk produced outsized price declines in assets investors have been using to position for so-called US debasement, or more colloquially "sell America." For instance, prices of gold and silver plunged the day of the announcement of his nomination by roughly 9% and 26%, respectively. Whether the judgment ultimately proves correct, the markets' sense that Mr. Warsh will not be a rubber stamp for the significantly lower interest rates Mr. Trump routinely calls for is a welcome stabilizing force, at least for the time being.

Index of Gold and Silver Prices (Index = 100 on 1 Jan 2026)



Source: CME.

In the grander scheme, short-term market fluctuations are just that and likely to pale in significance to the forward-looking "regime change" plans Mr. Warsh has been outlining in speeches and public writings. To be sure, it is one thing to muse about changes to the most powerful central bank in the world while a private citizen and another entirely to pursue such changes sitting atop said institution. But it is very much our judgment that Mr. Warsh intends to seek dramatic changes to the Fed's operations should he become the Chairman.

These changes are likely to encompass (i) the role of the US Fed staff; (ii) the Fed's balance sheet; (iii) financial sector regulation and structure.

US Fed Staff

The influence of the Fed staff will decline – probably by quite a good-sized amount versus the staff's current influence. The staff in recent years has been very influential in shaping policymakers' macro views and, in turn, policymaking decisions. This has owed to Chair Powell being neither a professional economist nor a macro practitioner and has been compounded by a Board and broader FOMC that has had a shortfall of real-world monetary policy experience and/or practicing macro experience.

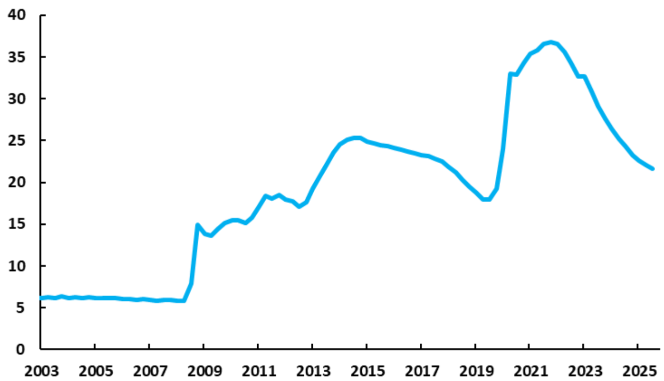
The staff's macro forecasts (recognizing we do not have direct access to them) often have seemed 'mechanical' in nature, i.e. overly tied to statistical models, and slow to reflect real-time developments such as the degree of technological adaptation and its effects on productivity. Given the Directors of both the International Finance and Research and Statistics divisions – which are responsible for producing the bulk of the staff's economic forecast – are 1990s MIT PhDs, the statistical modelling-heavy focus is not surprising. Separately, but related, reliance on the staff plus the shortfall of real-world macro experience of policymakers has contributed to the Fed's 'watch the data approach.' Recognizing the low volatility in month-to-month macro data in the United States absent a policy / financial / exogenous shock, this approach has resulted in too much backward-looking and insufficient forward-looking analysis. Case in point: Being extremely late to the 2021H1 to 2023 inflation surge.

A Chairman Warsh is highly likely to demand large-scale changes on these fronts. This may take many forms but result in complicated statistical models having reduced input in FOMC decision making.

US Fed Balance Sheet

Mr. Warsh's desire to shrink the Fed's balance sheet is well known and a contributor to the characterization of him as a policy hawk. While a good-sized portion of the balance sheet's COVID-era surge has been unwound, the balance sheet – and, by extension, the Fed's footprint in the US financial sector – remains roughly four times its pre-GFC (global financial crisis) size as a share of the economy. Outside the GFC balance sheet expansion to backstop the financial sector, Mr. Warsh has been a consistent critic of the enlarged balance sheet. His two dominant criticisms on this front have been that the enlarged balance sheet has contributed to capital misallocation and inappropriate central bank intervention into fiscal areas.

Federal Reserve Balance Sheet (% of GDP)



Source: Federal Reserve Board.

Conventional wisdom is that shrinking the balance sheet (outright and/or as a share of the economy) represents a *de facto* monetary policy tightening and thereby would be associated with somewhat higher longer-term bond yields, somewhat stronger USD and the associated generic implications for other asset classes such as equities and commodities. In short, a tightening of financial conditions that, in turn, likely would exert a directional drag on the pace of economic activity.

Importantly, a future Chairman Warsh cannot just wave his hands as Chairman and begin the process of shrinking the balance sheet. Whether it be action that can be taken by the Board of Governors or requires the full FOMC (the monetary policy committee), there are processes to be followed, consensus to be built and votes to be taken. Moreover, there is the incredibly significant issue of funding markets where US overnight and short-term funding has come to rely – for various reasons – on the Fed's current footprint in markets.

Financial Sector Regulation & Structure

On that score, full-steam ahead shrinkage of the balance sheet at some point would produce stress in funding markets – at least in the Fed's prevailing ample reserves framework and the existing regulatory environment. As a result, there will need to be substantial changes to the current financial sector regulatory framework if the balance sheet is going to be able to be shrunk back to something in the mid-teens as a percentage of GDP. Given previous funding market strains, scepticism is high whether the balance sheet can be reduced from its current position.

Neither we nor anyone can or should have any confidence that a Chairman Warsh will be able to reduce successfully the Fed's balance sheet along the lines implied by his prior comments. This is unchartered territory. But under the direction of Fed Governor / Vice Chair for Bank Supervision Bowman, changes to financial sector regulation already are rapidly afoot.

Regulatory changes on issues such as risk weights, collateral and liquidity requirements and other bank (and related entities) balance sheet and financial sector plumbing matters likely are necessary – at a minimum – to maintain stability in funding markets in a shrinking Fed balance sheet environment. Put differently and over simplifying, financial sector pools of capital will have to supplant Fed capital – or at least play a meaningfully larger role – as the lubricant of funding markets.

Whether shrinking the balance sheet along these lines and facilitating a more dominant role for private capital / capital providers in funding markets is viable is unknown. But the Fed is further down the deregulatory path on the financial sector than generally appreciated and a new Chairman could – likely would – accelerate that development. Moreover, the Trump Administration is high on reduced regulation, including of the financial sector.

Balance Sheet – Policy Rate Trade-off

In addition to major regulatory changes likely being necessary to maintain macro and financial equilibrium in a smaller Fed balance sheet world, it may be the case that a lower Fed policy rate also will be required. Debate around the balance sheet's stimulative effects – often couched in basis point equivalents of the traditional policy interest rate – have raged since Ben Bernanke first pulled the QE lever during the GFC. All such estimates are guesses and involve varying degrees of assuming one's conclusion.

Nonetheless, it is a reasonable deduction that balance sheet shrinkage along the lines Mr. Warsh has opined about likely would require some degree of offsetting policy action. Perhaps that would be the pending boost to disposable household income from last year's tax policy changes, although that is likely to be confined to 2026. Perhaps financial sector regulatory changes – especially if they embolden regional banks to step up credit creation – is such an offset. Or, perhaps, good, old-fashioned central bank interest rate cuts will be needed.

Summary

Kevin Warsh's Fed Chairman nomination introduces various uncertainties as to how the US central bank will influence the economy and markets in the period ahead. Structural changes will not be instantaneous. But make no mistake: Of the Chairman finalists, only Mr. Warsh articulated an agenda of significant change for the central bank. And change is coming that will seek to reshape how the Fed and markets have intersected in the post-GFC period; the history of shifts in policymaking frameworks is full of missteps (and volatility) and we would expect the same to apply here.

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