Fed meeting – Will Warsh grant Trump's wishes?

President Trump has appointed Kevin Warsh as Fed chair to push through rapid interest rate cuts. Warsh will preside over his first meeting next week. This meeting is likely to provide some concrete clues as to what changes Warsh has in mind. However, far-reaching changes are unlikely to be feasible in the short term.

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Warsh takes over from Powell ...

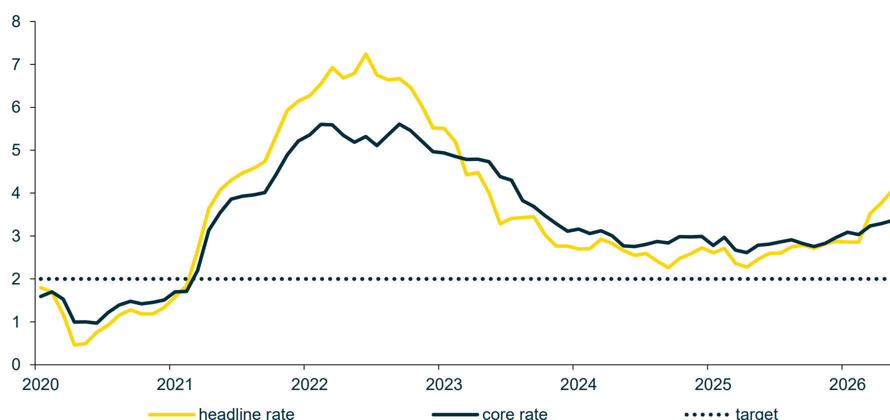
The U.S. Federal Reserve has had a new chairman since May 22: Kevin Warsh has replaced Jerome Powell as chairman of the Federal Reserve Board [1]. He will chair his first monetary policy meeting next week and hold his first press conference afterward.

Warsh was nominated by President Trump because the latter was dissatisfied with his predecessor's policies. This is because Powell had refused to lower interest rates despite massive pressure. Market participants will be looking to Warsh's first major appearance for clues as to the extent to which he will change the Fed's course. Although Trump recently said in a television interview that Warsh could do whatever he wanted and that he did not want to exert much influence over him, Trump nevertheless made it clear that there was no reason to raise interest rates. In an earlier interview, Trump admitted that he would not have selected Warsh if the latter had told him that he intended to raise interest rates [2].

... but for now there is no majority in favor of interest rate cuts, ...

However, an interest rate cut is unlikely to be seriously on the table next week. This is because inflation risks have continued to rise since the last meeting in April. Based on the comprehensive inflation measure preferred by the Federal Reserve—the deflator of personal consumption expenditures (PCE) —prices in April were 3.8% higher than a year earlier. The core rate, excluding energy and food, stood at 3.3%. Since most of the data used to calculate the PCE deflator for May is already available, a further increase to 4.1% (headline rate) and 3.4% (core rate) is foreseeable (Chart 1). So far, the war in Iran has mainly manifested itself in higher gasoline prices, while second-round effects on other goods and services—such as those resulting from higher transportation costs—have remained limited. However, without a prompt end to the conflict in the Persian Gulf and the resulting decline in energy prices, this is likely to change in the coming months.

Chart 1 - US inflation moves further away from target
Personal consumption expenditures deflator (PCE), year-on-year change in %. Last value (May 2026) forecast

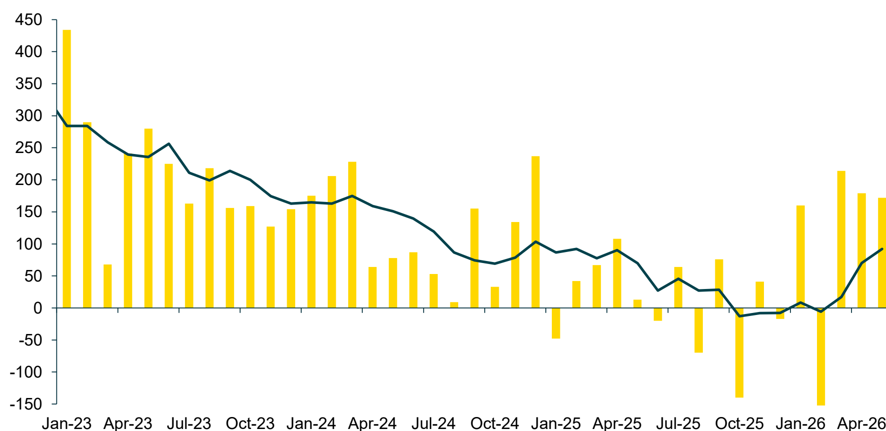


Source: BEA, S&P Global, Commerzbank Research

Since the inflation rate is well above the Fed's 2% target and is actually moving further away from it, a rate cut would only be justified if the Fed were to completely miss its second goal of full employment. In fact, the labor market has recovered from the slump it experienced last fall. At that time, the unemployment rate had risen to 4.6%, prompting the Fed to cut rates three times.

However, the unemployment rate has now stood at 4.3% for several months, which is roughly the level the Fed considers ultimately unavoidable. Over the past three months, more than 100,000 new jobs have been created each month, a trend last seen in early 2024 (Chart 2). Even though wage pressure has eased, which should dampen inflation, the labor market does not currently support interest rate cuts.

Chart 2 - Trend in US payroll growth picks up again
nonfarm payrolls, month-on-month change in thousands. Line: six-month moving average



Source: BLS, S&P Global, Commerzbank Research

… and the "easing bias" may even be dropped

In fact, some Fed officials are unhappy that the statement released after the interest rate meeting still includes a reference to the central bank considering "further adjustments" to interest rates—that is, further rate cuts. In their view, this "easing bias" no longer fits the economic situation. Rather, the central bank should at least adopt a neutral stance. At the last meeting, three of the twelve members of the Open Market Committee therefore voted against the monetary policy decisions.

We expect the central bank to remove the "easing bias." While Kevin Warsh will have no objection to an interest rate cut as the next step, he generally does not believe in signaling future interest rate moves. He could therefore agree to calls to eliminate the wording, even if he does not share the substantive arguments.

As for the actual interest rate decision next week, Warsh has two options for pushing through monetary easing. He could vote for a rate cut himself. This would secure Trump's approval. However, he would likely be the only one to do so and would clearly be outvoted. This would be a highly unusual situation for a Fed chair, one that could undermine his authority.

Or Warsh could vote to keep rates unchanged in an attempt to pick up the other FOMC members—who, at least for now, oppose a rate cut—and then, over time, steer the majority opinion in the desired direction. We consider the latter scenario more likely and, as far as Warsh's goals are concerned, more promising.

In the medium term, Warsh is counting on support from AI …

Warsh won't have a better chance of pushing through an interest rate cut until next year. By then, the inflation rate is expected to fall again, as the price-driving effects of tariffs and the higher energy costs resulting from the conflict in the Persian Gulf should begin to subside. In addition, Warsh expects that the introduction of artificial intelligence (AI) will significantly boost productivity, as was the case during the "New Economy" of the 1990s and early 2000s. Back then, productivity rose significantly for several years, which helped keep the inflation rate low despite robust economic growth.

Although productivity has recently shown somewhat more favorable trends, the major boost from AI has so far been more hope than reality, and lowering interest rates in anticipation of future productivity gains would certainly be a risky endeavor. After all, five years of elevated inflation have left their mark; against the backdrop of these experiences, the inflation expectations of consumers and investors are likely no longer as firmly anchored as before. Since this is a major concern for many Fed members, Warsh is likely to find it difficult to push through significant interest rate cuts in the coming period as well.

… and has other plans as well

Warsh not only has different ideas about future interest rate policy than the majority of the FOMC. He is dissatisfied with other aspects of the monetary policy pursued in recent years and plans to make changes:

- **Change in communication:** According to Warsh, the Fed talks too much. In particular, forward guidance would tie monetary policy down too tightly, and necessary adjustments might then come too late. The dot plot—the quarterly publication of Fed members' assessments of the future path of the federal funds rate—is on Warsh's chopping block. However, no rapid change is expected here; rather, this is likely to be discussed and prepared internally first. Thus, the dot plot will be published as scheduled next week.
- **A leaner Fed balance sheet:** Warsh criticizes the constant expansion of the Fed's operations. He would like to significantly reduce the Federal Reserve's balance sheet again. While the Fed's balance sheet amounted to about 6% of gross domestic product (GDP)

before the financial crisis, it recently stood at 21% of GDP. This is significantly less than the 35% reached in 2022; however, a return to the old ratio of 6% would likely only be achievable with a regime change in how the financial system is supplied with central bank money. Currently, the Fed operates in an environment of "abundant reserves." Bank reserves—that is, banks' deposits with the Fed —amount to about $3 trillion. Before 2008, by contrast, they were only about $10–20 billion. At that time, the supply of liquidity to banks was ensured in the interbank market through trading in scarce central bank funds. A return to the old system could only take place gradually to prevent disruptions in the money market. Furthermore, if the Fed were to reduce its balance sheet, it would have to reduce its Treasury bond portfolio, which, to avoid market disruption, would likely only be possible over a longer period of time through the maturities of the held Treasuries.

- **Review of inflation measurement:** Warsh has doubts about whether inflation measures such as the core rate accurately reflect price pressures. He would likely have an assessment conducted to determine whether other indices should be relied upon—for example, those that exclude the most extreme price movements and do not merely leave out food and energy prices. However, this seems more like a discussion of nuances; after all, the Fed has been calculating such alternative metrics for quite some time.

What all these initiatives have in common is that they are hardly feasible in the short term but require considerable lead time. Warsh will likely establish working groups to develop concrete proposals. A radical change in course is not necessarily implied by some of these plans anyway. After all, the Fed has already adjusted its course in recent years. For instance, it has been reducing its balance sheet since the end of the COVID-19 pandemic and has withdrawn from areas outside its purview, such as climate policy. This is already a response to the fact that the Fed has increasingly come under scrutiny by Congress due to its actions during the crises. From this perspective, Warsh would merely reinforce a trend that is already underway.

What does this mean for the Fed's independence ...

Warsh argues that a central bank can only be independent if it limits itself to a very narrow mandate. Otherwise, it ventures into areas that are actually reserved for fiscal policy and should not be surprised when the people's elected representatives demand control and a say in the matter. Seen this way, Warsh's advocacy for a lean Fed can also be viewed as an attempt to safeguard the independence of monetary policy in the core area of monetary policy.

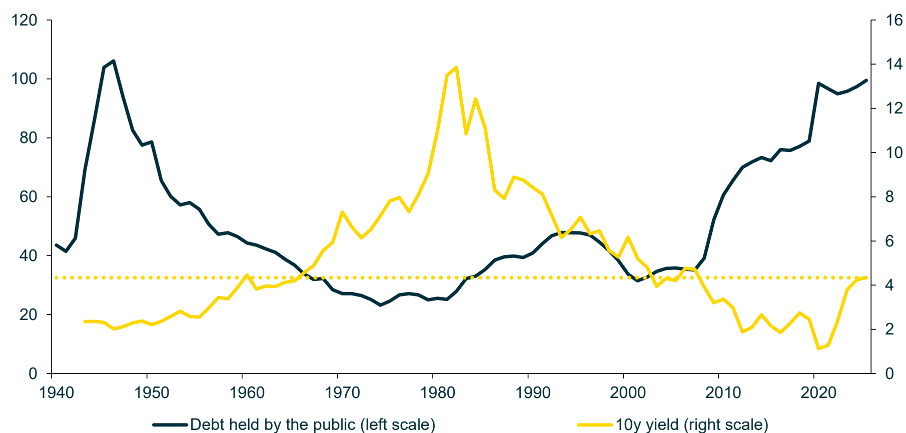
The question, however, is whether this can succeed. The Trump administration has interfered in monetary policy in many ways, from constant calls for interest rate cuts to the proceedings against Powell and Governor Lisa Cook. Even if these interventions were ostensibly unsuccessful, they are likely to have left an impression on current and future monetary policymakers.

This threatens to erode the Fed's independence, as the explicit political pressure is unlikely to change—certainly not during the remainder of President Trump's term. Furthermore, the interplay between monetary and fiscal policy is shifting toward "fiscal dominance." This refers to a situation in which monetary policy must increasingly take the government's poor fiscal position into account in its decisions. As a result, it could find itself forced to ensure government financing by setting key interest rates lower than inflation would require or by purchasing large quantities of government securities to suppress yields and thus financing costs.

The risk of such a development is certainly high. After all, an aging and polarized society makes it difficult to reduce high budget deficits and pushes fiscal policy onto an unsustainable path. Currently, the U.S. federal government's debt level is nearly as high as it was at the end of World War II (Chart 3). To ensure the refinancing of the debt, the Fed capped long-term yields at 2.5% at that time. Should debt rise as expected and yields continue to climb, debt service could become politically unsustainable. Then one might recall the third part of the Fed's mandate, which is often overlooked: In addition to ensuring price stability and full employment, Congress has also tasked the Fed with maintaining **"moderate long-term interest rates"**.

Chart 3 - "Fiscal dominance": The Fed's independence is at risk

US federal government debt held by the public in % of GDP, 10-year Treasury yield in %, annual data



Source: White House, CBO, Fed, Commerzbank Research

… and what about our forecast?

We continue to expect that, due to inflation risks, calls for interest rate hikes will grow louder in the coming months, but that this will not become the prevailing view within the FOMC. If the situation in the Persian Gulf eases and oil prices—and thus the inflation rate—fall again, sentiment is likely to shift and the question of interest rate cuts will resurface. Starting around the middle of next year, the Fed will likely begin cutting interest rates, by 75 basis points through the end of 2027. This is likely to put pressure on the dollar. For fall 2027, we expect EUR/USD to be at 1.21.

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[1] The Federal Reserve Board has seven members and thus holds a majority on the Federal Open Market Committee (FOMC), which makes monetary policy decisions. The Chair of the Board is typically also the Chair of the FOMC and thus exerts significant influence over U.S. monetary policy. Warsh's term as chairman of the Board is four years, ending on May 21, 2030. As a regular member of the Board, he could remain in office until 2040. (back to text)

[2] Warsh used to have a reputation as a hawk on inflation. However, that reputation has faded since he advocated for interest rate cuts under a Republican president. It is therefore no surprise that Warsh has come to be seen as somewhat opportunistic, or at the very least as someone who favors the Republican Party. (back to text).

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