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# Changing of the guard at the Federal Reserve

## What may change under Kevin Warsh – and what probably won't

Last week, after much back and forth, the U.S. Senate confirmed Kevin Warsh, Donald Trump's pick to chair the Federal Reserve (Fed). Warsh can now formally take over from Jay Powell, who also entered the job eight years ago as Trump's preferred candidate. The president's admiration for Chairman Powell has visibly cooled, not least because Powell refused to bow to the royal – sorry, presidential – wish for lower interest rates. Will Trump be happier with Warsh?

Judging by Warsh's public remarks, a great deal at the Fed is meant to change. He has even talked of a [regime change](#). But reality is usually less dramatic than the rhetoric. The constraints of the economic environment are likely to rein in Warsh's ambitions. Any promises he may have dangled in front of Trump will be hard to turn into policy.

### Rising inflation stands in the way of rate cuts

Consider interest rates. Owing to the war in the Persian Gulf, U.S. inflation has shot up again. In April it stood at 3.8%, almost twice the target (see fig. 1). In February, before the war broke out, it was still 2.4%. And the direction of travel is almost certainly upwards. So far, [food prices](#) are roughly where they were before the Iran war, but they normally follow energy prices sooner or later. Nor is there any sign that [energy prices](#) will soon return to earlier levels, even if the Strait of Hormuz were miraculously to reopen tomorrow.

Warsh's claim that he sees scope for rate cuts is unlikely to command a majority in the twelve-member Federal Open Market Committee (FOMC) – all the more so as Powell will, for now, stay on as an ordinary member of the Fed's Board of Governors.

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May 22, 2026

## Trump gets rid of "Too Late Powell"

Fig. 1: US Inflation Rate (in %, year-on-year)



Source: Federal Reserve Bank of St. Louis, LBBW Research

Warsh argues that artificial intelligence (AI) will lift productivity and thus dampen price pressures. But when that effect will show up in consumer prices is anyone's guess. At the same time, the voracious energy demand of vast data centers is structurally pushing up electricity prices – and, with them, the cost of almost everything else. The semiconductor shortages triggered by the gargantuan AI investments may also give inflation an extra nudge in the short run.

Warsh is just one of twelve FOMC members. He [cannot sack other committee members](#), contrary to what some people still seem to believe. Since the war began, the committee as a whole has become more hawkish. Recently, a growing number of members have even wanted the faintest hint of a future rate cut stripped out of the Fed's statement.

I suspect that, in private, Warsh sees things much the same way. Kevin Warsh is not [Kevin Hassett](#), the director of Trump's National Economic Council and loyal ally, who was once also discussed as a candidate for Fed chair. Hassett would probably have been Trump's puppet. Warsh, a seasoned central banker and financial sector veteran, rather less so.

### Balance-sheet reduction: easier said than done

Warsh has served as a Fed governor before. He resigned in 2011 in protest at the Fed's large-scale purchases of U.S. Treasuries. His ostentatious dislike of the Fed's bloated balance sheet is therefore credible. The Fed has already tried to shrink its securities holdings (see fig. 2). The result was market turmoil, as liquidity proved patchily distributed across the financial system. Forcing through a strict balance-sheet diet could again trigger serious indigestion in financial markets. Warsh can hardly want that run the risk of a liquidity crisis.

Running down the central bank's holdings is thus likely to remain a long-term project. In the near term, not much is likely to change. That is a far cry from a radical overhaul of monetary policy, or "regime change".

### Monetary-policy transparency may suffer

Warsh is no fan of press conferences – Powell doubled their frequency – nor of the so-called "[dot plot](#)", which anonymously aggregates FOMC members' interest-rate expectations. If the Fed were indeed to scale back or discontinue both practices, investors would lose information they have come to rely on when making financial decisions. During the transition, that could translate into greater market volatility.

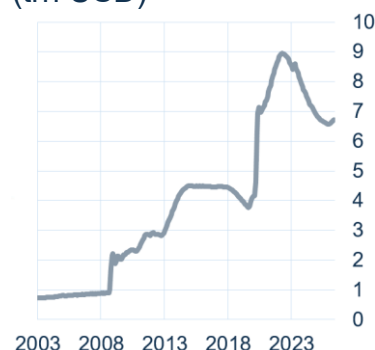
All the more so if, under the new chair, the inflation gauge used to judge price stability were to change. Warsh favors more stable metrics such as median inflation or "trimmed mean inflation", which strip out volatile components like energy, food, cars, airline tickets and the like. Investors could see this as an attempt at manipulation – a suspicion no central bank is keen to invite.

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## Only one in twelve

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Fig. 2: Balance Sheet Federal Reserve (trn USD)



Source: Federal Reserve Bank of St. Louis, LBBW Research

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## Warsh: silence is golden

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