# Flash Economics

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# What can be inferred about the monetary policy Kevin Warsh would like to pursue

The future Chair of the Federal Reserve, Kevin Warsh, has provided some indications regarding the monetary policy he would like the central bank to pursue:

- a reduction in short-term interest rates, possibly made feasible by the development of artificial intelligence and the associated productivity gains;
- a resumption of quantitative tightening to reduce the size of the Federal Reserve's balance sheet.

If such a policy is indeed implemented, it would lead to a significant steepening of the yield curve in the United States (a decline in short-term interest rates and an increase in long-term interest rates).

The effects of this policy are difficult to assess:

- the dollar exchange rate would be weakened by the decline in short-term interest rates but supported by stronger demand for long-term U.S. Treasury securities;
- the credibility of the Federal Reserve would be negatively affected by the reduction in short-term interest rates while inflation remains above the 2% target, but the increase in long-term interest rates would slow investment (both in real estate and by firms) and economic growth;
- the U.S. stock market reacts positively to lower short-term interest rates but negatively to higher long-term interest rates, overall leading to an ambiguous reaction in stock market indices.

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## The monetary policy Kevin Warsh likely wants to pursue

The future Chair of the Federal Reserve, Kevin Warsh, has advocated two ideas regarding the monetary policy he would like the Federal Reserve to pursue:

- **a fairly significant reduction in short-term interest rates** (**Chart 1** shows market expectations regarding the future path of short-term interest rates, which still remain above 3.2% today);
- **a resumption of quantitative tightening** in order to reduce the size of the Federal Reserve's balance sheet (**Chart 2**).

**Chart 1**
**United States: Eurodollar contracts (3-month)**

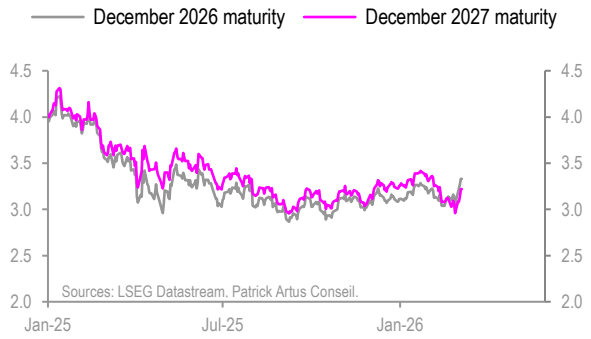
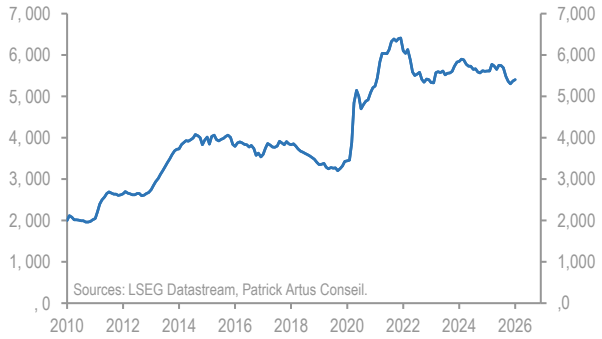
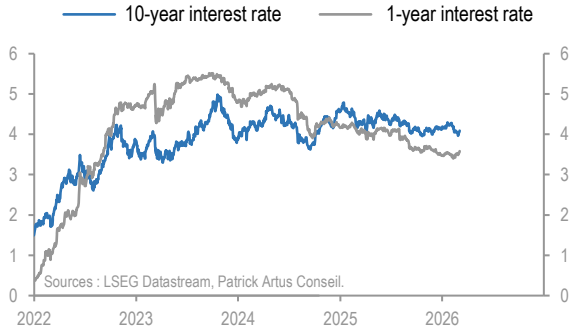



**Chart 2**
**United States: Monetary base (USD bn)**




If such a policy were effectively implemented in the future, **it would lead to a significant steepening of the yield curve in the United States**, with a decline in short-term interest rates and an increase in long-term interest rates (**Chart 3**).

**Chart 3**
**United States: Interest rate on 1-year and 10-year government bonds (as %)**



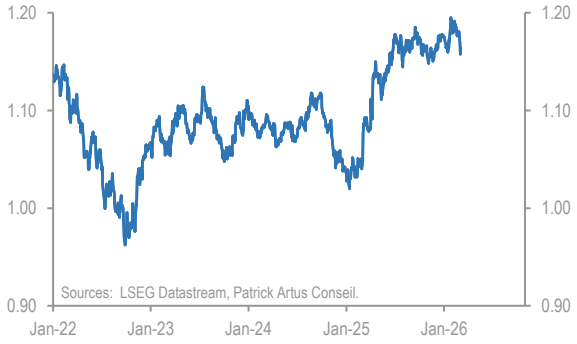

This is the trend that has been observed since October 2025, but it would be much more pronounced if there were indeed a substantial reduction in short-term interest rates combined with a resumption of quantitative tightening.

## What would be the effects of this monetary policy?

### 1. On the dollar exchange rate

The dollar exchange rate would be weakened by the decline in short-term interest rates but strengthened by increased demand for long-term U.S. Treasury securities. **Overall, the effect on the dollar exchange rate (Chart 4) would therefore be ambiguous and limited.**

Chart 4
Euro-dollar exchange rate (EUR 1 = USD...)




## 2. On the credibility of the Federal Reserve

Lowering short-term interest rates while **inflation remains above the Federal Reserve's inflation target** (2%, **Chart 5**) is unfavourable for the credibility of the central bank, and it could therefore lead to an increase in long-term inflation expectations (**Chart 6**). Kevin Warsh is known to believe that the introduction of artificial intelligence will generate significant productivity gains and lead to lower inflation.

Chart 5
United States: Headline inflation and core inflation (as %)

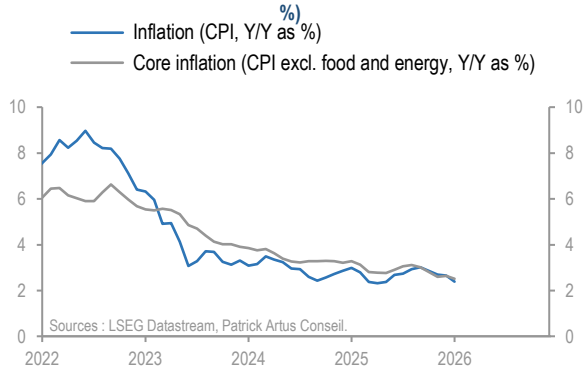
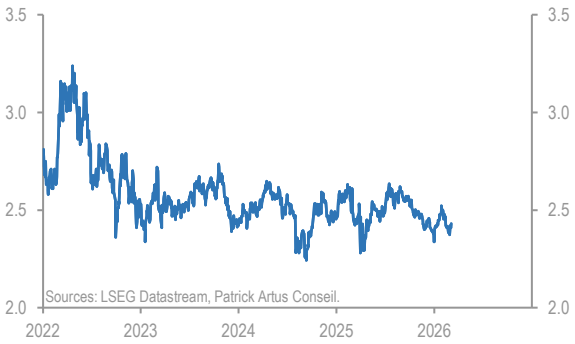



Chart 6
United States: 10-year inflation swaps (as %)




On the other hand, the increase in long-term interest rates will also **slow both residential investment and corporate investment** (**Charts 7 and 8**), which will reduce economic activity and, in turn, inflation. The negative effect on the credibility of the Federal Reserve from a reduction in short-term interest rates combined with a shrinking of the Federal Reserve's balance sheet may therefore not be very significant.

Chart 7
United States: Private residential investment (in volume terms, as % of real GDP)

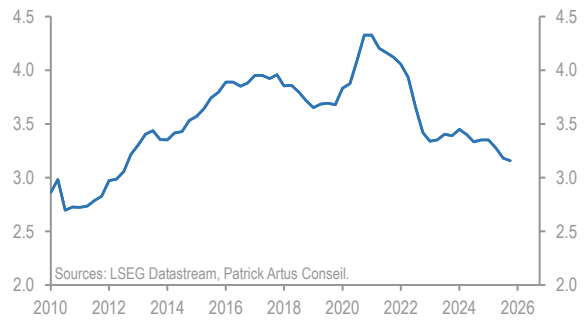



Chart 8
United States: Non-residential private investment (as % of nominal GDP)

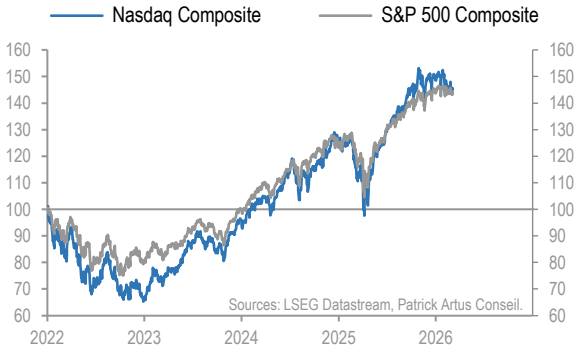



## 3. On the U.S. equity market

**The stock market reacts positively** to a decline in short-term interest rates (which, for example, makes margin credit less costly), **but reacts negatively** to an increase in long-term interest rates (which theoretically reduces the price-to-earnings ratio). The overall

effect on U.S. stock market indices of a policy leading to lower short-term interest rates and higher long-term interest rates would therefore **be**, **a priori, ambiguous** (**Chart 9**).

**Chart 9**
**Stock market indices (01.01.2022 = 100)**




## Summary: A limited effect on the dollar exchange rate, the credibility of the Federal Reserve, or the U.S. equity market

If the Federal Reserve, after Kevin Warsh becomes its Chair, were indeed to implement a policy of reducing short-term interest rates while shrinking the size of its balance sheet, the effects of such a policy would likely be limited:

- **on the dollar exchange rate** (a decline in demand for short-term dollar-denominated securities, offset by stronger demand for dollar-denominated bonds);
- **on the credibility of the Federal Reserve** (a loss of credibility due to the reduction in short-term interest rates while inflation remains above target, offset by the dampening effect of higher long-term rates on investment, growth, and therefore inflation);
- **on U.S. stock market indices**, since movements in short-term and long-term interest rates would have opposing effects on these indices.

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