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WARSHONOMICS UNPACKED

Berenberg Macro View

From one lawyer to another: Pending Senate confirmation, Kevin Warsh will succeed current Fed Chair Jerome Powell as soon as Powell's term ends on May 15. Like Powell, he is a lawyer by training, but unlike Powell, he has strong incentives and ambitions to "shake things up" at the Fed. Like all other candidates for the Fed Chair job, he favors lower rates (not much of a surprise here). What sets him apart is his strong desire for a leaner Fed balance sheet. Warsh wants the Fed to play a reduced role in the financial markets and not sustain an "asset-rich, income-poor" economy that would fuel inequality. We are sympathetic to this idea -- the Fed's bloated balance sheet (see Chart 1) did play a role in containing financial risks and helping Wall Street thrive while Main Street continued to struggle. However, Fed plumbing and the liquidity regulations are too complicated (and have gotten even more so since the Fed switched from a scarce reserve framework to ample reserves in 2019) for the Fed to shrink its balance sheet abruptly without rewriting regulations and changing the framework. Doing so could easily cause a crisis in the short-term funding markets – especially when overnight reverse repo facilities at the Fed are near zero and bank reserves are already on life support from the Fed's reserve management purchases. In short, without rewriting the playbook, the Fed cannot shrink its balance sheet suddenly without "breaking anything." Markets would probably sniff out any clumsy attempts and penalize them by moving away from US assets, resulting in a weaker dollar. The risk of such an adverse market reaction could stop such attempts in their tracks.

An easier and less painful alternative to leaner balance sheet: Warsh is a vocal critic of the Fed's quantitative easing not only because of its "reverse Robin Hood effect," but because it also results in what he calls "mission creep." He believes that, as the Fed intervenes in financial markets, it expands beyond its original goal (the dual mandate of price stability and maximum employment). In other words, does a central bank responsible for low and stable consumer price inflation really need to hold more than $2 trillion in mortgage-backed securities? One way to address this "mission creep" is for the Fed to simply shrink its securities holdings. But given the current reserve levels, regulations, and elevated Treasury General Account balances (likely to stay so as the government shifts issuance more to the short end), that would probably not be feasible without triggering stress in repo markets (remember when the Secured Overnight Financing Rate spiked nearly 20bp on 31 October and market participants were tapping the Fed's Standing Repo Facility like there was no tomorrow?). An easier and less painful alternative to move away from the "mission creep" would be to change the Fed's asset composition and let it simply consist of Treasury bills. In that case, the Fed's balance sheet expansion would add to bank reserves with minimal footprints. It is more likely than not that the Fed, under Warsh's leadership, takes this approach first before moving to deregulation (a revisit to the Supplementary Leverage Ratio or a recalibration of the Liquidity Coverage Ratio?) and balance sheet shrinkage.

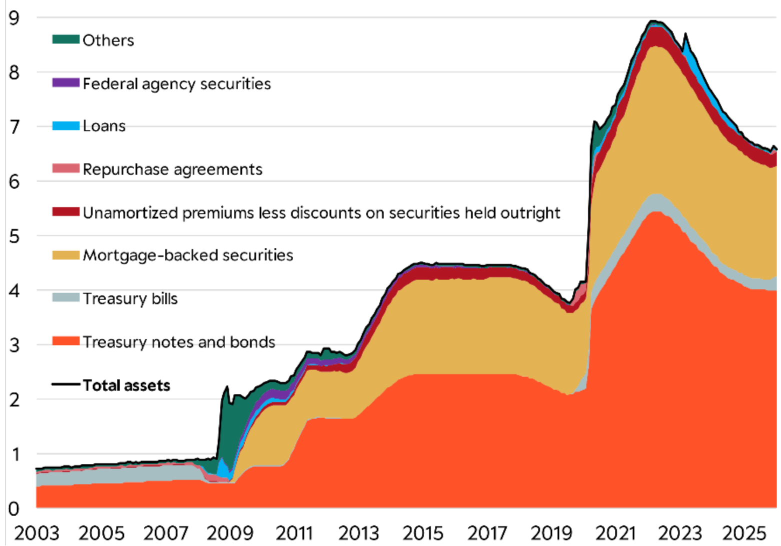
Reminiscent of 1960s? The ideal Fed that Warsh (and the Trump administration) want is quite reminiscent of the Fed in the mid-1960s under Chair William McChesney Martin Jr. Back then, fiscal policy was in the driver's seat while monetary policy was more of a passenger princess. When the US government introduced the first Keynesian tax cut in 1964 (the Kennedy-Johnson tax cut became law in February 1964), monetary policy did not attempt to "take the punch bowl away". Instead, it simply let the party continue. In 1965, it was Goldilocks: solid growth, low and stable inflation, and strong labor markets. Simply put, monetary policy accommodated an expansionary fiscal policy by not tightening the money supply. The Trump administration seems to want to go back to those times, when fiscal policy had more footprints in the economy. After all, fiscal policy has much better tools than monetary policy (which can only really control the short end of the curve). In other words, monetary policy should support fiscal policy and not counteract it. But if nobody takes the punch bowl away, inflation will simply spiral out of control. That is exactly what happened in the late 1960s. The Johnson government took the Keynesian stimulus idea too far, sharply increasing its deficit-financed government spending (mostly due to Vietnam War-related spending). As the Fed did not tighten the belt beforehand (monetary policy works with lags), inflation surged in the late 1960s. It then later took a substantial fiscal and monetary policy contraction to fight the inflation, but the tight policies suppressed demand enough to result in a recession in 1970. President Donald Trump seems to want 2026, ahead of the midterm elections in November, to be just like 1965. But history shows that what comes after is not too rosy.

We all were hawks at some point: The commentary about how Kevin Warsh was hawkish following the 2008 Global Financial Crisis misses the point. First of all, that was 17 years ago. As Fed watchers would know, Fed officials can learn on the job and shape-shift from hawk to dove and dove to hawk quite quickly. Remember that Austan Goolsbee was one of the most dovish Fed officials early last year but had switched to the hawkish side by the end of the year? If Fed officials can change their stance within a year, so can Warsh in 17 years. Even the "perma-hawks" sometimes become doves, as Warsh seems to have done on rates.

AI and productivity: Like many others, Warsh believes in an artificial intelligence-led productivity boom. Coupled with some deregulation, that should bring enough disinflation and hence allow the Fed to lower rates further. Not a too-controversial take, but the future productivity gains from artificial intelligence adoption are more of a "hope" rather than "prediction," as there is simply not much evidence to back it up. Such an approach of waiting for productivity increases is similar to the "opportunistic disinflation" strategy that the Fed undertook under Chair Alan Greenspan in the mid-1990s. Policymakers back then did not aim to actively suppress demand to lower inflation and instead waited for an expansion on the supply side of the economy. While the same can be done this time, Warsh has to convince the rest of the committee that a productivity boom is around the corner. Although recent productivity gains have actually come from the industries that adopted artificial intelligence in their operations the most -- namely, information, finance, and professional & business services -- it is hard to tell if the relationship is causal. Maybe industries with higher productivity growth have more room to invest in AI, or their existing infrastructures make it easier to adopt. And even if it is causal, the relationship may not be linear. Further adoption of AI may only boost productivity a little bit. Basically, there is not much evidence yet to convince the rest of the FOMC committee to "trust" that AI-driven productivity will counteract any potential pick-up in inflationary pressures.

What is the trade here? The most likely outcome, in our view, is for a Warsh Fed to shift the Fed's asset composition primarily to Treasury bills (with the sole purpose of "reserve management") and move away from other asset classes gradually. Under the assumption that thereafter balance sheet reduction is done gradually, with rewriting of regulations and adjusting the framework, and the Fed delivers a final 25bp rate cut in June under new leadership, as we expect, the yield curve should steepen. The uncertainty stemming from attempts to "regime change" at the Fed should result in a weaker dollar.

Chart 1: Fed's balance sheet still bloated at $6.6 trillion



In $ trillion. Sources: Haver Analytics, Federal Reserve, Berenberg.