US Rates Strategy

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Key principles rather than forward guidance

Fed Chair Warsh laid out his criticism of forward guidance and provided some clues about what a more data-dependent Fed will be watching. However, these are more "key principles" than a contingent or scenario-based reaction function.

- Warsh remains deeply critical of forward guidance particularly the sort used during the financial crisis and during COVID. **He argues that deterministic, pre-committed guidance leads to policy errors once the economy normalizes as occurred after COVID.**

- While economists now widely accept that pre-committing to keep rates low for long is ill-judged once the economy is off the zero lower bound, there is more debate about other forms of forward guidance.[1] The Fed could, for example, outline its medium-term outlook while highlighting the risks in the forecast and how it might react. **Mapping out a reaction function anchored to a forecast allows policy to remain flexible and data dependent**. The market judges for itself what the Fed is likely to do by comparing the current data to the medium-term forecast. Alternatively, it could provide scenarios that outline possible policy paths. **Either way, policy is contingent on the state of the economy and the data flow**.

- However, Warsh seems a little skeptical about even this type of guidance. **He argues that forecast-based guidance works "better in the lab than in the field"**. For example, he notes that FOMC members consistently forecasted inflation would return to 2% despite signs it wasn't after COVID.

- **Instead, he believes policy should be guided by a set of "key principles"**. This means putting more emphasis on "trends" rather than "isolated data". Policy is implemented through changes in short-term interest rates; rather than QE. **Price stability is defined by the PCE index** – although in his discussion of current conditions he noted other measures including the dispersion of prices within the CP as well as commodities. That said, he thinks wages are less helpful for predicting inflation. **Finally, he argues that "we should pay attention to money created by the central bank"**. We think this is an oblique reference to the size of the Fed's balance sheet.

- **While the Chair clarified the general principles guiding policy, these may still not be detailed enough to give a sense of how the Warsh Fed will respond to different economic scenarios**. Markets were relieved that he sounded more hawkish and reiterated the Fed's 2% PCE goal for price stability. But without more direction, the Fed and markets are in a bit of a hall of mirrors – each reflecting back what it thinks the other is thinking.

[1] See, "Current Issues in Forward Guidance", T. Adrian, International Monetary Fund, August 2026.

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