Kevin Warsh's Hardest Choice Yet

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When the Federal Reserve meets on September 15 and 16, Kevin Warsh will face the first major test of his chairmanship.

Inflation remains well above the Fed's 2% target. The labor market, after appearing to weaken earlier in the summer, regained momentum in August. Long-term Treasury yields have climbed, placing more pressure on the federal government's borrowing costs. The Treasury Department has responded by expanding purchases of longer-dated securities to support market liquidity. President Donald Trump, meanwhile, continues to argue for lower interest rates.

Each development points in a slightly different direction. Taken together, they create an unusually difficult decision.

Warsh must decide whether to raise the federal funds rate, leave it unchanged at 3.50% to 3.75%, or cut it. Yet the meeting is about more than 25 basis points. It will show whether the new chairman can respond to the economic evidence without allowing political pressure or market expectations to dictate monetary policy.

That may be harder than it sounds.

Inflation Is Still the Central Problem

The latest data offer little support for the idea that inflation has been defeated.

The Consumer Price Index rose 0.4% in August after increasing only 0.1% in July. Consumer prices were 3.4% higher than a year earlier, far above the Fed's 2% objective. Core CPI, which excludes food and energy, rose 0.3% for the month and 2.4% over the preceding 12 months (U.S. Bureau of Labor Statistics [BLS], 2026a).

Some of the August increase came from energy. Gasoline prices jumped 3.9% and accounted for more than one-third of the monthly rise in headline CPI. Overall energy prices climbed 2.1%, while shelter costs increased 0.3%.

That composition matters. Higher gasoline prices caused by geopolitical instability or supply disruptions do not necessarily indicate that demand throughout the economy is

excessive. Interest-rate increases cannot produce more oil, repair disrupted shipping routes, or end a geopolitical conflict.

Still, the Fed cannot dismiss the report as an isolated energy shock. Core inflation remains above target, and other measures show continuing price pressure.

The Producer Price Index for final demand rose 0.4% in August, with prices for final-demand goods climbing 1.1%. Producer prices were 5.4% higher than a year earlier (BLS, 2026b). Rising costs for producers do not pass automatically to consumers, but an increase of that size raises the risk that businesses will try to recover higher expenses through their prices.

The Fed's preferred inflation gauge is even less reassuring. The Personal Consumption Expenditures price index rose 3.7% over the year through July, while core PCE inflation reached 3.3% (Bureau of Economic Analysis [BEA], 2026).

Not every measure is accelerating at the same rate. That is not the point. The problem is that none of the major measures has established a convincing path back to 2%.

Warsh Inherited This Problem, but Now He Owns the Response

Warsh became Fed chairman on May 22, 2026. Although he served as a Federal Reserve governor from 2006 to 2011, he did not make the policies that produced the post-pandemic inflation surge. He inherited this inflation problem.

He has also inherited responsibility for solving it.

At the Jackson Hole Economic Policy Symposium on August 28, Warsh stressed the importance of price stability and suggested that the Fed could have "work to do" if inflation failed to move convincingly toward its objective (Warsh, 2026).

Those remarks now constrain his options. If the Fed cuts rates only weeks after that speech, with CPI inflation at 3.4% and PCE inflation at 3.7%, Warsh will need a compelling explanation. He would have to show either that inflation is likely to fall quickly or that the labor market is deteriorating badly enough to outweigh the inflation risk.

Neither case is easy to make from the latest data.

A new chairman's words matter because markets are still learning how he will react to changing conditions. If his public standard for action shifts too quickly, investors may begin to doubt the consistency of the Fed's policy framework.

The Labor Market Weakens the Case for a Cut

The August employment report gave Warsh another reason to proceed cautiously.

Nonfarm payrolls rose by 162,000, well above economists' expectation of 56,000. The unemployment rate held at 4.1%, labor-force participation increased to 61.6%, and average hourly earnings were 3.1% higher than a year earlier (BLS, 2026c).

These figures do not describe an overheated labor market. Wage growth has slowed, and a 4.1% unemployment rate is not, by itself, evidence of dangerous labor shortages.

But the report did weaken one of the best arguments for cutting rates: that employment was declining abruptly.

June and July had raised legitimate concerns about the labor market's direction. The August rebound changed the picture. July's initially reported payroll decline was also revised to a gain of 21,000.

The Fed is therefore confronting an awkward combination. Inflation remains too high, but the labor market has not collapsed. Employment growth has slowed, but recent data do not indicate an emergency. This leaves policymakers without an obvious reason to ease and without a completely straightforward case for tightening.

Treasury Is Trying to Relieve Pressure at the Long End

The Treasury market adds another complication.

On August 19, the Treasury Department announced that it would at least double the maximum size of its longer-dated liquidity-support buybacks, from $2 billion to at least $4 billion per operation beginning September 9. The purchases cover securities with maturities ranging from 10 to 30 years (U.S. Department of the Treasury, 2026a).

On September 9, Treasury announced a buyback of up to $6 billion involving securities in the 10- to 20-year range. The progression was notable: from a $2 billion maximum, to at least $4 billion per operation, and then to a $6 billion transaction.

Treasury says the purpose is to improve liquidity by purchasing older, less frequently traded securities. These operations are not the same as quantitative easing. When the Fed conducts quantitative easing, it creates reserves to purchase securities as part of monetary policy. Treasury buybacks are debt-management operations.

Still, the transactions can affect the market. Removing selected long-term securities from public circulation can improve trading conditions and provide some support to long-duration bonds.

The scale should not be exaggerated. A $6 billion operation is tiny next to a Treasury market worth more than $30 trillion and the government's vast financing needs. It cannot

determine long-term interest rates on its own. Long-term yields remained elevated even after the program expanded.

That tells us something important. Treasury may be able to improve liquidity at the margins, but it cannot erase investors' concerns about inflation, federal borrowing, or future interest rates.

Japan's Role Is About Preventing Sales, Not Encouraging Purchases

The connection between Japan and the Treasury market is more complicated than the claim that Washington wants Japan to buy more U.S. debt.

The more immediate concern is that Japan could sell Treasuries to obtain dollars during a large currency intervention. Because Japan is one of the largest foreign holders of U.S. government debt, substantial sales could push Treasury prices lower and yields higher.

In late July, the United States and Japan carried out an unusual coordinated intervention to support the yen. Japan reportedly spent about ¥15.4 trillion, or roughly $98.7 billion, between July 30 and August 26, while its foreign reserves declined sharply.

Treasury Secretary Scott Bessent later supported expanding the Federal Reserve's Foreign and International Monetary Authorities repo facility. The FIMA facility allows foreign official institutions to borrow dollars against Treasury securities rather than selling those securities into the market. Its current limit is $60 billion.

The logic is simple: support the yen, reduce the risk of disorderly Treasury sales, protect market liquidity, and limit additional upward pressure on U.S. yields.

This is not a campaign to persuade Japan to purchase more Treasuries. It is an attempt to prevent currency stress from becoming bond-market stress.

The White House, Treasury and Fed Want Different Things

An unusual policy configuration is now taking shape.

Treasury is trying to ease pressure on longer-term yields through buybacks and liquidity operations. The White House wants lower interest rates. The Federal Reserve must set short-term rates according to its mandates of maximum employment and stable prices.

Those goals do not necessarily align.

A Fed rate cut could reduce short-term yields. It would not guarantee lower long-term borrowing costs. Long-term Treasury yields reflect expected future rates, inflation expectations, federal borrowing needs, term premiums and investor demand. If markets

interpret a rate cut as evidence that inflation control has become secondary to government financing costs, long-term yields could remain high, or climb further.

That is the paradox: lowering the federal funds rate does not always lower the rates that matter most for mortgages, business investment and government borrowing.

History offers a warning. During World War II, the Fed cooperated with Treasury efforts to keep government borrowing costs low. The inflation that followed helped lead to the 1951 Treasury-Federal Reserve Accord, which restored greater monetary-policy independence.

The United States is not reliving 1951. The narrower lesson still applies: when monetary policy becomes subordinate to the government's financing preferences, preserving confidence in price stability becomes harder.

Markets Are Now Expecting a Hike

The debate around the September meeting has shifted dramatically.

Earlier in the summer, investors focused on possible rate cuts. That expectation has been reversed. After Warsh's Jackson Hole speech, market-implied odds of a September rate increase approached 60%. The strong August employment report reinforced that view. After the August CPI report on September 11, the implied probability of a hike reportedly rose to roughly 82% to 87%, depending on the source and timing of the market snapshot.

That shift changes the meaning of each possible decision.

A 25-basis-point hike would broadly match market pricing and reinforce Warsh's inflation-fighting message. It would also put the Fed directly at odds with the administration's demand for lower borrowing costs.

Holding rates steady would surprise investors positioned for a hike. Yet it would preserve the Fed's ability to wait for evidence that the energy-driven increase is spreading into broader inflation.

A cut would be the largest surprise. It would move policy in the direction favored by the president, but the Fed would struggle to reconcile it with the latest inflation and employment figures.

Warsh is not simply choosing between tightening and easing. He is choosing which risk the Fed is most willing to tolerate.

A Hold Is Defensible, but Only With the Right Explanation

There is a serious case for leaving rates unchanged at 3.50% to 3.75%.

The case is not that current policy is plainly restrictive enough. Relative to headline PCE inflation of 3.7%, the midpoint of the target range is only modestly restrictive on an ex-post basis. Relative to core PCE inflation of 3.3%, the real policy rate is more clearly positive, though hardly severe.

The better argument for holding is that the Fed needs more information.

Much of the latest CPI increase came from gasoline and energy. If those prices stabilize, headline inflation could ease without another rate increase. If they feed into transportation, goods and services prices, the Fed may need to act.

Holding would preserve flexibility. Policymakers could monitor whether the energy shock broadens, whether inflation expectations continue to rise, and whether August's employment strength persists. They could tighten later if the evidence points to a lasting inflation problem.

This would not amount to surrendering to political pressure. It would be a judgment that the Fed should not damage employment and investment in response to a supply shock that monetary policy cannot directly fix.

Still, a hold would carry real danger.

Inflation has remained above target for years. Headline PCE is 3.7%, core PCE is 3.3%, CPI is 3.4%, and producer inflation is 5.4%. Payroll growth rebounded in August, and unemployment remains low at 4.1%.

Inflation expectations have also become more sensitive. The University of Michigan's preliminary September survey showed one-year expectations rising to 4.6% and five-year expectations reaching 3.4%.

If households and businesses begin to treat inflation above 2% as normal, waiting becomes costly. Workers demand higher wages, businesses raise prices more readily, and lenders demand greater compensation. The Fed may then need sharper rate increases later to restore confidence.

The Message May Matter More Than the Rate Change

The most consequential part of the September meeting may not be the rate decision itself. It may be Warsh's explanation.

If the Fed holds, he must explain why inflation at 3.4% on CPI and 3.7% on PCE does not require immediate action.

If the Fed hikes, he must explain why a partly energy-driven shock warrants greater restraint even as wage growth moderates.

If the Fed cuts, the burden will be heavier. He must explain why easing is appropriate when inflation remains high and employment has just exceeded expectations.

Markets need to understand the Fed's reaction function: which evidence changes policy, how quickly it does so, and why. Is the committee responding to gasoline prices, persistent core inflation, employment weakness, inflation expectations, Treasury-market stress, or some combination of them?

A credible central bank does not have to satisfy investors at every meeting. It does not have to grant the president's preferred rate. It does have to apply a recognizable set of principles consistently.

The Real Test Is Independence

President Trump has repeatedly said U.S. rates should be lower. On August 31, he expressed confidence that Warsh would "do what he has to do" while again arguing that the United States should have among the lowest interest rates in the world.

Presidents have long preferred cheaper credit. Lower rates can support growth, housing, asset prices and government financing. The harder question is whether those preferences influence the central bank's judgment.

Congress gave the Fed the goals of maximum employment and stable prices, then provided it with meaningful independence in pursuing them. Research has repeatedly found a relationship between greater central-bank independence and lower inflation, though the strength and mechanism of that relationship vary across countries and periods.

That institutional design exists for meetings like this one.

Warsh did not create the inflation he inherited, but he now owns the response. Treasury buybacks, foreign-exchange intervention, the FIMA facility and the administration's preference for cheaper financing do not alter the Fed's mandate. Neither does futures-market pricing.

If the evidence supports a hike, the Fed should hike. If policymakers determine that the latest inflation increase is temporary and that the labor market is weaker than the headline payroll figure suggests, a hold can be justified. A cut would require the strongest argument because the latest data point in the opposite direction.

The defining question on September 16 is not whether rates finish the day 25 basis points higher or lower. It is whether the new chairman shows that the Fed's decisions remain

anchored to inflation and employment rather than the immediate demands of Washington or Wall Street.

That is Kevin Warsh's real test.

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