Fed chief sets the stage for interest rate increase

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28 August 2026

In what probably could best be described as an exercise in damage control, Federal Reserve chair Kevin Warsh has sought to dampen down fears in financial circles that he is not prepared to react to persistent inflation by raising interest rates.

Warsh had come under fire following the Fed meeting in July, after his remarks following a decision to keep rates on hold were regarded as not sufficiently clear on what his reaction to continuing inflation would be.

Delivering the keynote address to the Jackson Hole, Wyoming banking symposium yesterday, he sought to address those concerns.

There were two key sections of his address regarded as being crucial to his commitment to tackle this issue.

Setting out his principles, he said: “There should be no misunderstanding. The Fed’s price-stability objective of 2 percent, as measured by the personal consumption expenditures (PCE) price index, is a firm, fixed target. Let’s be equally clear about another aspect of the objective: Price stability is not self-executing, nor is inflation necessarily mean-reverting. It is the Fed’s job to deliver stable prices.”

He took issue with concerns that a weakening of the labour market could indicate a slowing of the economy, maintaining that it was “consistent with full employment.”

But on the price-stability side of the Fed’s mandate, “the numbers are more concerning,” with the Fed’s preferred measure of inflation, the PCE index, at 3.7 percent and the six-month change at 4.1 percent. The consumer price index (CPI) was also elevated.

“None of these measures are perfect, but they all tell a similar story: Inflation is running above our 2 percent target. So the Fed’s predominant focus right now should be on prices.”

And then to emphasise the point, he added that while the summer PCE and CPI readings had been “better than expected, they do not tell me that underlying trends have meaningfully improved.”

“Here is my standard: we must be confident that underlying inflation is moving to our objective, clearly and at sufficient speed,” he said. “Otherwise, we have work to do.”

There was a significant market reaction to these remarks. The probability of a rise in the Fed rate at its meeting next month jumped from 35 percent the previous day to 62 percent. The yield, interest rate, on two-year Treasury debt rose by as much as 0.11 percent points to 4.34 percent, a significant increase.

Comments cited by the *Financial Times* (FT) summed up the general sentiment in financial markets.

Priya Misra at JP Morgan Asset Management said: “It is a hawkish speech.” Warsh was making “a forceful statement that [policymakers are] committed to price stability.”

She said the speech was a “forceful pushback to what I think was miscommunication at the July press conference. … And so I’m seeing today as the clean-up act.”

Matthew Amis, investment director at the global financial firm Aberdeen, said the speech “sets up a September meeting where if they don’t hike, credibility will take another bashing.”

If the Fed does raise rates at its September meeting, just two months before the mid-term elections, it could set up a clash with US President Trump, who relentlessly denounced former Fed chair Jerome Powell as a “numbskull” and a “moron” for not lowering rates.

He appointed Warsh in the hope that he would be more accommodating, and has said that while Warsh wants to lower rates, he is constricted by a “political” governing body. The continuing attempts by the administration to remove governor Lisa Cook are an indication he is working to try to change that situation.

One of the most discussed features of Warsh's tenure so far is the abandonment of so-called "forward guidance," where the Fed gives an indication of how it will react to changes in market conditions. He maintains that this creates the conditions where markets are not reflecting changes in the economy but are basing themselves on what they think the Fed might do.

Warsh used his speech to defend his opposition to forward guidance, saying it set up a "hall of mirrors."

But as has been pointed out by numerous commentators, the Fed plays a vital role in the determination of the economic fundamentals to which markets react because it controls short-term interest rates.

The key issue, according to a comment by Robert Armstrong in the FT, was not its forecasting of the direction of the economy but that its credibility was determined by the communication of its "reactive function"—that is, how it would react to changes in economy.

Armstrong asked, "If not through forecasts, how to make this known? Warsh raised this crucial question [he said market participants would always try and anticipate what the Fed would do] and answered it only with virtuous generalities about humbleness and empiricism. The market will not be satisfied with that for long."

Besides the possible conflict with Trump if rates are raised, there is already another conflict developing, in this case between the Treasury and the Fed.

This has arisen from the decision of Treasury Secretary Scott Bessent that purchases of long-term bonds could be increased from $2 billion to $4 billion per operation, and possibly even more, in an attempt to lower their yields.

This was denounced in a scathing op-ed piece in the *Wall Street Journal* by long-time Wall Street trader Stanley Druckenmiller—a one-time mentor of both Bessent and Warsh. He said the market's verdict on the announcement, as yield initially fell and then rapidly rose again, was "swift and correct."

"This wasn't liquidity management, it was price management—a mistake far larger than $4 billion suggests," he wrote.

Druckenmiller then indicated one of the underlying issues—the demand by key sections of the financial oligarchy for attacks on spending for key social services and facilities.

"The long-term Treasury yield is the most important price in the world. It is also the only fiscal disciplinarian the US has left. Neither party will run on entitlement reform."

So-called "reform" is the code phrase used by the oligarchs for a deep offensive against the working class.

But Bessent seems determined to press ahead, claiming that the higher bond yield does not reflect fundamentals, and has let it be known through Treasury "sources" that the department could use the $1 trillion Treasury General Account through which it conducts the daily operations of government to make bond purchases.

That such an unprecedented measure could even be considered shows the growing concern that the rise in bond yields is indicative of the development of a crisis caused by the escalation of US national debt, which earlier this month passed the $40 trillion mark with the interest bill running at $1 trillion annually.

If the Fed, as indicated by Warsh, does go ahead with an interest rate increase at its next meeting—with at least three members of its interest-rate setting body indicating that they favoured such a rise at the July meeting—it will conflict with the Treasury intervention at the long end of the market.

This is because the Treasury will finance its bond purchases by issuing more short-term debt under conditions where interest rates will be rising as a result of an increase in the Fed rate. In other words, the two economic arms of the capitalist state will be pulling in opposite directions—another expression of the deep-seated tensions and contradictions within the US financial system.