



Flossbach von Storch
RESEARCH INSTITUTE

MACROECONOMICS 27/08/2026

The Fed Should Follow the Early ECB

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Abstract

Kevin Warsh wants to reshape the Fed. The early ECB's two-pillar framework offers a blueprint for a broader approach to monetary policy.

Zusammenfassung

Kevin Warsh will die Fed neu ausrichten. Das Zwei-Säulen-Modell der frühen EZB bietet einen Rahmen für eine breiter aufgestellte Geldpolitik.

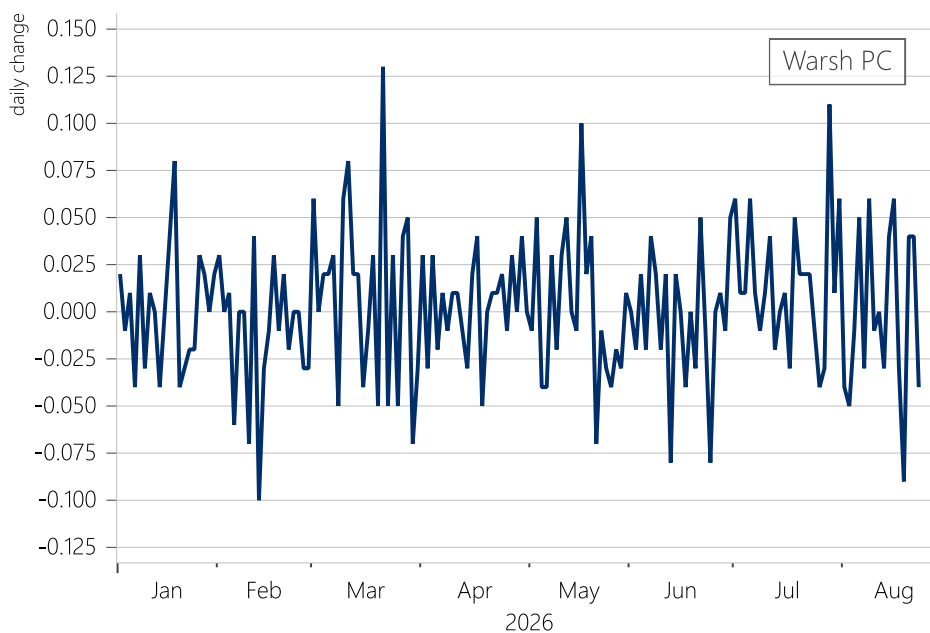


The US Federal Reserve has a mandate to ensure price stability and full employment. Its main instrument for achieving these goals is the interest rate paid on banks' central bank reserves. The federal funds rate influences bank lending rates, which affect yields on US bonds, then the US stock market, while both ultimately shape capital markets worldwide. This makes the Fed the world's leading interest-rate planning authority. No wonder the world pays attention when the Fed gets a new chairman.

The "Warsh Shock"

Even before Kevin Warsh took office, it was known that he wanted to shrink the Fed's balance sheet, swollen by bond purchases, and abolish advance guidance on future interest-rate paths ("forward guidance"). But at his first press conference, his statement on how interest rates should be determined more by markets than by Fed policy unsettled some commentators and the bond market. The rise in the 30-year Treasury yield after the press conference was the third largest since the start of the year (see chart). As long as the Fed uses the interest rate as an instrument of policy, it remains the most important player in this market. Warsh's statement therefore appeared inconsistent.

Yield on 30-Year US Treasuries



Source: Flossbach von Storch Research Institute, Macrobond, U.S. Treasury. Data as of August 21, 2026.

Monetary Policy Needs Recalibrating

Still, Warsh has good reasons to recalibrate monetary policy. With total assets of more than 20 percent of GDP, the Fed has become a cumbersome fund for government bonds and government-backed mortgage securities that distorts market price formation and is exposed to political influence. Second, announcing a future interest-rate path can tempt investors to take greater risks. Third, recalibration is



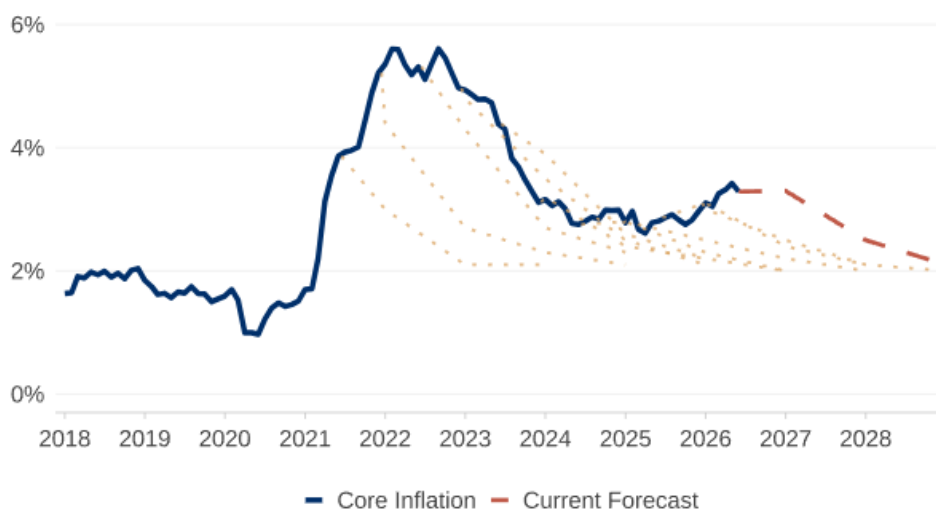
warranted because inflation has remained above the two percent target for five years (see chart). Over this period, the Fed's inflation forecasts were persistently too optimistic. The projected return to the two percent target has had to be pushed back for five consecutive years. Fed officials now expect it only in 2028 (see chart).

US: Consumer Price Inflation



Source: Flossbach von Storch Research Institute, Macrobond, BLS. Data as of July 2026.

Federal Reserve: Core Inflation vs. Forecast (Core PCE, y/y, %)



Source: Flossbach von Storch Research Institute, Federal Reserve, BEA. Data as of May 2026.



To review the monetary-policy framework, Warsh has created five “task forces” that will examine, among other issues, the Fed's balance sheet, models for explaining inflation, and communication. It would be consistent for the task forces to recommend a further reduction of the balance sheet and the abolition of forward guidance. The European Central Bank and the Bank of England have already moved in this direction.

Inflation Has Several Drivers

More interesting may be the recommendations of the task force on explaining inflation and the strategy for fighting it. There is much evidence to suggest that inflation can have several drivers, each becoming important in different circumstances. At times it is wage growth in an overheated labor market, at others excessive money creation, and sometimes supply shocks such as higher oil prices that push up the price level (Mayer 2024). If inflation has several dimensions, however, it cannot be explained and fought with a one-dimensional model. Different explanations require different points of attack. Monetary policy therefore needs a broader approach.

The ECB's Original Monetary-Policy Strategy

Fortunately, this approach does not need to be invented from scratch. Under its first chief economist, Otmar Issing, the European Central Bank had already recognized that a broad framework could better reflect the complexity of inflation's drivers. In its Monthly Bulletin of November 2000, the ECB stated:

"In the presence of considerable uncertainties surrounding the structure of the economy and the transmission mechanism of monetary policy within this structure, when formulating monetary policy central banks should not rely on any single indicator, single model or simple policy rule to take policy decisions. Rather, a diversified approach to the analysis of the information underlying monetary policy decisions is desirable." ECB, Monthly Bulletin, November 2000, p. 37.

Issing developed a framework that combined real-economy and monetary considerations. Monetary analysis was to play a "prominent role" because, over the medium term, inflation is ultimately a monetary phenomenon. This "pillar" was to be complemented by a second one examining how real-economy developments, such as labor-market tensions or external shocks, affected inflation.

As elsewhere, the ECB's monetary-policy instrument was the interest rate on banks' central bank reserves. Banks use central bank money to settle transfers of deposit money through corresponding transfers of central bank money between their accounts at the central bank, without having to refinance these transfers in the inter-bank money market. Regulation also requires them to hold minimum reserves in central bank money.



As was common at the time, the ECB kept the supply of central bank money scarce. Banks had to borrow central bank money in weekly repo operations at the ECB's policy rate. Unexpected reserve needs could be met at higher rates through the marginal lending facility, while reserve surpluses could be parked at lower rates in the deposit facility. The money-market rate was anchored to the rate on the main refinancing operations.

At first, the ECB offered central bank money in its weekly main refinancing operations at a fixed rate, initially 3.0 percent, and rationed bids proportionally when demand exceeded supply. The aim was to give banks guidance in the new environment. But by setting the interest rate exogenously, the central bank overrides the market process of price discovery. After the initial adjustment period, the ECB therefore moved to variable-rate tenders in 2000.

Under variable-rate tenders, banks submit bids for the amount of central bank money they want and the interest rate they are willing to pay. The central bank allocates funds at the bid rate and cuts individual allocations once the desired total amount has been reached. Banks that urgently need central bank money bid high rates; those that need little bid low rates. Variable-rate tenders allow the central bank to control the quantity of central bank money while the interest rate emerges endogenously from the balance of supply and demand.

The ECB Dilutes Its Approach

The existence of a good framework does not guarantee that it will endure. The ECB's later development shows how quickly such an approach can be abandoned. From the start, adherents of New Keynesian economics strongly criticized the ECB's two-pillar model. They argued that money was irrelevant for inflation and that monetary analysis was a relic of the past. Inflation, they claimed, could be explained by the Phillips curve alone. The persistent criticism had consequences. During the financial crisis, the ECB moved in 2008 to fixed-rate tenders with full allotment, supplying all liquidity demanded at an interest rate set by the central bank.

In effect, the ECB abandoned control over the quantity of central bank money, which had played an important role in the two-pillar model. With the start of bond purchases under quantitative easing in 2015, it moved to steering interest rates by creating excess central bank reserves in the banking system. The deposit rate then became the key determinant of the interbank money-market rate and, ultimately, of lending rates in the economy.

Finally, in its strategy review at the start of the 2020s, the ECB merged the two pillars into an "assessment of all relevant factors" in relation to the inflation target. Its 2021 Monetary Policy Strategy Statement reads:

" This assessment builds on two interdependent analyses: the economic analysis and the monetary and financial analysis. Within this framework, the economic analysis focuses on real and nominal economic developments, whereas the monetary



and financial analysis examines monetary and financial indicators, with a focus on the operation of the monetary transmission mechanism and the possible risks to medium-term price stability from financial imbalances and monetary factors. The pervasive role of macro-financial linkages in economic, monetary and financial developments requires that the interdependencies across the two analyses are fully incorporated. This framework reflects the changes that the ECB's economic analysis and monetary analysis have undergone since 2003, the importance of monitoring the transmission mechanism in calibrating monetary policy instruments and the recognition that financial stability is a precondition for price stability. The ECB's Monetary Policy Strategy Statement (2021).

In practice, the strategy review paved the way for an interest-rate policy based on wholly unrealistic "Dynamic Stochastic Equilibrium" models built on post-Keynesian theory.

After these inflation models failed during the pandemic years, and after the delayed response to the subsequent rise in inflation, the ECB stressed in its new 2025 monetary-policy strategy: " In particular, it takes into account not only the most likely path for inflation and the economy but also surrounding risks and uncertainty, including through the appropriate use of scenario and sensitivity analyses."¹ *The post-Keynesian models disappeared from view. The focus on "monetary and financial indicators" remained, but now apparently without theory and merely "data dependent".*

Back to the Roots

Repeated inflation forecast errors and monetary-policy mistakes in the United States and Europe provide ample reason to recalibrate the monetary-policy framework. The new Federal Reserve chairman appears to understand this better than the ECB's current leadership. It is quite possible that the Fed under Warsh will restore the monetary perspective.

Even before his appointment, Warsh had criticized the absence of money from the monetary-policy debate and called for its return to the analysis.² The first Monetary Policy Report under his leadership accordingly states that a measure of the money supply can "play a role in assessing financial and economic conditions."³ Greg Mankiw, a prominent economist on Warsh's inflation task force, argued in 2024 that it was time to reconsider the widespread neglect of monetary aggregates.⁴

¹ See the ECB Monetary Policy Strategy Statement (2025).

² "I think money, strangely enough, has something to do with monetary policy. It has been absent from the discussion." Kevin Warsh, July 8, 2025. <https://www.hoover.org/research/inflation-choice-kevin-warsh-fixing-federal-reserve>.

³ Federal Reserve, Monetary Policy Report, July 2026, p. 32. Monetary Policy Report, July 2026

⁴ Mankiw, N. G. (2024). Six Beliefs I Have About Inflation: Remarks Prepared for NBER Conference on "Inflation in the Covid Era". Journal of Monetary Economics, 103631.



If Warsh used the early ECB framework for this recalibration, inflation analysis and monetary policy could again rest on a broader foundation. Bringing monetary developments back into focus could also weaken the central bank's fixation on setting the policy rate, which Warsh rightly criticizes. If liquidity operations instead targeted quantities, the interest rate would emerge endogenously, as in the ECB's former variable-rate repo operations.



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