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## WASHINGTON POLICY STRATEGY

# Potomac Perspective

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Kevin Warsh's confirmation hearing and the Senate's work on a reconciliation bill are the two big policy events of this week. Warsh's main audiences will be the president and the markets rather than the Senate. He is likely to be confirmed as the next Federal Reserve Chairman although the timing remains uncertain.

The Senate's work on a budget resolution (a precursor to a reconciliation bill) could determine whether the latter is a skinny bill with little impact on tax policy, or a fatter bill that could include large offsets including changes to the tax code. We expect that the Senate will adopt the limited approach.

- History and voters' current views on the economy point to a good midterm election for Democrats. This is especially the case in the **Warsh confirmation hearing**. On Tuesday, the Senate Banking Committee will hold a confirmation hearing on Kevin Warsh's nomination to be the next chairman of the Federal Reserve Board. The timing of Warsh's confirmation remains uncertain. Senator Thom Tillis (Republican-North Carolina) has vowed to block any Fed nominee until the Department of Justice (DOJ) concludes its investigation of the renovation of the Fed's headquarters and Chairman Jerome Powell. Tillis has signaled his support for Warsh but is withholding his vote pending the outcome of the DOJ inquiry. Once that matter is disposed of, we think it is **highly likely that Warsh will be confirmed – it's when, not if. Since Warsh seems to have enough votes to eventually be confirmed, his primary audiences will be President Trump (he needs to keep Trump happy at least until confirmation) and the markets, which have questions about Warsh's views on monetary policy and related matters.**
  - **Warsh's evolving views on monetary policy** – Warsh supported the initial round of quantitative easing (QE) but became a vocal critic of subsequent rounds of QE. That shift initially led to the perception that Warsh was an inflation hawk, but his subsequent support of lower interest rates (due to the disinflationary impact of artificial intelligence and other productivity gains) has now shifted views of him which put him in the dove camp. We expect that he might support a more cautious view on cutting interest rates while the war in Iran continues, but we also expect that he may support cuts once the situation is resolved. Warsh will need to show Trump that he will follow through on the president's agenda for easier monetary policy. Deviating from that position could endanger his nomination.
  - **Fed independence** – Committee members will undoubtedly ask questions about Warsh's views on Fed independence. We expect that he will enthusiastically support that concept, but he could connect his answers regarding central bank independence to his answers on monetary policy. He may argue that the Fed itself, through QE, has undermined this principle. In Warsh's view, the Fed lost its independence to the Treasury due to the increase of the Fed's balance sheet and holdings of Treasuries under QE. The markets will be looking for signals on how Warsh might have the Fed further shrink its balance sheet while cutting rates.
  - **Regulatory policy** – Given the focus on Fed independence and monetary policy, Warsh might not be asked about banking regulation. However, if committee members ask him about it, then we expect that he will be supportive of the Trump administration's deregulatory agenda. This should not be surprising to investors, but we think headlines on regulation could be positive for the banking industry.

- **Reconciliation** – Senate Republicans could release their budget resolution this week as an initial step toward passing a reconciliation bill by Mr. Trump’s self-imposed deadline of June 1.
  - **Reconciliation process primer** – As a reminder, the reconciliation process allows Congress to pass a budget bill through the Senate with only a simple majority of votes rather than the typical 60 votes. There are numerous rules and restrictions on the use of reconciliation. Among them is the requirement that the House and Senate pass an identical budget resolution. No budget resolution, no reconciliation. The former is merely an outline of what the budgetary targets are that the relevant committees need to reach. The actual reconciliation bill will be written later. As part of the process of passing a budget resolution, the Senate holds a “vote-a-rama” during which amendments can be offered to the resolution. The amendments can be politically tough votes that are intended to embarrass the other party, but the amendments must be germane to the budget resolution. The broader a budget resolution, the broader the list of potential amendments.
  - **Skinny or fat?** – Republican leaders want to pass a reconciliation bill that would fund immigration enforcement agencies (skinny bill). Since this approach targets just a couple of government agencies, it would not include offsets including potential offsets in the tax code. However, some conservative Republicans want to go big and make deeper cuts in spending (fat bill) than what was done in the One Big Beautiful Bill Act (OBBBA). As we mentioned in a previous note, a fat bill could revisit numerous changes to the tax code that were floated during the debate over OBBBA but were ultimately dropped.
  - **Skinny is the likely approach** – Conservatives might prefer a “go big” approach, but their fat bill could create numerous problems for the leadership. Moderates are unlikely to support additional cuts in social spending or back controversial tax law changes ahead of the midterm election. Also, by limiting the bill and the budget resolution, Republicans would protect vulnerable members from casting uncomfortable votes on popular programs. The skinny approach is the path of least resistance and seems to be the likely outcome.

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