OPINION

How Would the Fed Raise Rates?

With banks chock full of excess reserves, the federal-funds rate may prove useless as a tool to drain liquidity.

By GEORGE MELLOAN

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Central bankers at the Jackson Hole symposium on Friday heard a lot of talk from Federal Reserve Chair Janet Yellen about the labor market, over which central bankers have proved to have only limited influence. They heard very little about global asset inflation, over which they could have a lot of influence.

Yet the Fed is in no mood to exercise such influence. As expected, Ms. Yellen said the time is not ripe to raise short-term interest rates, ending six years of a near-zero ("zirp") policy and restoring something more closely resembling financial normality. Wait until next year remains the Fed's motto.

Given the risks of a resulting stock market crash or political uproar, it may not happen even next year unless some crisis, internal or external to the Fed, forces Ms. Yellen's hand. Meanwhile, savers and investors will continue to be denied a proper return on their investments and multibillion-dollar pension funds will flirt with insolvency.

A question mostly unasked at Jackson Hole is a crucial part of today's when-will-it-happen guessing game: Exactly how would the Fed go about draining liquidity if a burst of inflation urgently presented that necessity. The traditional mechanism used by the Fed no longer looks to be serviceable.

Before the "zirp" binge began in 2008, the Fed's primary monetary policy tool was the federal-funds market, overnight lending among banks to balance their reserves in compliance with the Fed's required minimums. The Fed withdrew liquidity by selling Treasurys to the banks and increased it by buying Treasurys. Fed-funds rates moved accordingly, becoming the benchmark for short-term lending rates throughout the economy.

But thanks to the Fed's massive purchases of government and mortgage-backed securities from the banks over six years of "quantitative easing," the banks no longer need to worry about meeting the minimum reserve requirement. They're chock full of excess reserves, to the tune of $2.9 trillion. For all practical purposes, the federal-funds market no longer exists.

Fed economists undoubtedly have given the absence of the traditional interest-rate control mechanism some thought. Stanley Fischer, the International Monetary Fund and Bank of Israel veteran who was

Federal Reserve Chair Janet Yellen speaks with European Central Bank President Mario Draghi at the Jackson Hole Economic Policy Symposium in Jackson Hole, Wyo., Aug. 22. *Reuters*

brought into the Fed as vice chairman in June, indirectly addressed it in an Aug. 11 speech. Asking himself whether the Fed still has the tools to manage interest rates, he came up with answers that sounded, well, tentative.

Mr. Fischer said that the Fed, for instance, could regulate the money supply by paying higher interest on the excess bank reserves on deposit at the Fed, thus holding them in check. That was an eye opener. The Fed could persuade the banks to tighten credit by bribing them with higher returns on their reserves?

What would these higher interest payments on reserves do to the Fed's earnings on its $4.5 trillion portfolio? The Fed returned only about $80 billion to the U.S. Treasury last year, not a huge amount to finance the massive largess imagined by Mr. Fischer. How would the politicians react to huge payouts to banks, including foreign-owned institutions, for the purpose of making credit more expensive?

He also mentioned another "tool," reverse repos, basically overnight borrowing by the Fed. The Fed already is active in the repo market, offering lenders the equivalent of up to five basis points in interest. It does this mainly to give favored lenders like Fannie Mae and Freddie Mac a payoff similar to what the banks get on their reserves. But why would it want to destroy its own earnings by borrowing at a higher rate than it does now? The repo market is far broader than the old fed-funds game, encompassing lenders of all stripes. It might not be as easy to manipulate.

Mr. Fischer also mentioned "other tools" that he did not describe. One might take a guess. A new buzzword at the Fed, frequently employed by the academic-minded Ms. Yellen to describe policies available in her toolkit, is "macroprudential" measures. What this expansive word means is not entirely clear, but a simple translation might be "muscling the banks" to bend to Fed diktats. Mr. Fischer used the term often in his speech.

The 2010 Dodd-Frank law, which was enacted on the premise that banks should be punished for the sins committed by politicians, enlarged the muscle power of the Fed and other federal agencies that regulate the financial industry. None of them have been timid about using that power.

The Fed, well attuned to politics, was engaged in mission creep even before Dodd-Frank, having entered the new game of credit allocation in response to the 2008 crisis. It began buying great masses of toxic mortgage-backed securities as a favor to the powerful housing lobby. Paying interest on excess reserves was its gift to big banks, even as Dodd-Frank was putting them under stricter capital requirements and forcing them to write "living wills" describing how they can be "resolved" should a crisis force them into insolvency. (The response from Goldman-Sachs, in essence: "We would declare bankruptcy." Duh.)

So presumably "macroprudential" measures are now to become a more important part of the Fed's money management. If the Fed can't control interest rates, the dollar supply and inflation by any other means, maybe it hopes to do it by fiat. Well, the dollar is a fiat currency so perhaps its management by fiat was inevitable.

But then the question arises: Is anyone at the Fed, even the estimable Mr. Fischer, smart enough to do that without precipitating some new financial disaster?

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Correction: A previous version of this article misstated what the Federal Reserve pays in interest on reverse repos.