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A Legal Barrier to Higher Interest Rates

If the Federal Reserve chooses to tighten monetary policy, it will have to do so legally.

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Defending the Federal Reserve's recent decision to put off raising interest rates again, Fed Chair Janet Yellen told reporters last week that she and other Fed governors wanted "to see some continued progress" before taking that step. Politics, she insisted, had nothing to do with it.

What Ms. Yellen didn't say is that the Fed couldn't raise its rates without breaking the law. Since when are Fed rate increases illegal? Since the 2007-08 subprime meltdown and financial disaster, actually.

Until then the Fed could set any target it liked for the federal-funds rate—the interest rate banks pay for overnight loans of cash reserves. To keep the fed-funds rate from rising above target, the Fed pumped more reserves into the banking system. To keep it from dropping below, it took reserves away.

But after Lehman Brothers failed in 2008, the Fed's efforts to keep the fed-funds rate from dropping below its target proved futile. To set a floor on how far the rate could go, the Fed started paying interest on banks' reserve balances with the Fed, taking advantage of the 2006 Financial Services Regulatory Relief Act giving it permission to do so.

Alas, it didn't work. Government-sponsored enterprises Fannie Mae, Freddie Mac and the Federal Home Loan Banks, which also kept deposit balances at the Fed but weren't eligible for interest on reserves (IOR), started making overnight loans to banks at rates below the IOR rate. In effect, this turned what the Fed hoped would be a floor on the fed-funds rate into a ceiling. To raise rates now, the Fed increases the rate on reserves.

So what's to keep the Fed from raising rates this way again? The 2006 Financial Services Regulatory Relief Act is what. For that law only allows the central bank to pay interest on reserves "at a rate or rates not to exceed the general level of short-term interest rates."

The rub is that the Fed's IOR rate of 50 basis points (0.5%) already exceeds the closest comparable market rates: those on shorter-term Treasury bills. At the start of this month, the four-week T-bill rate was just 26 basis points; since then it has slid even lower, all the way down to 10 basis points. Judging by these numbers, the Fed is already flouting the law. Another hike would mean flouting it all the more flagrantly. Lawmakers will be duty-bound to object.

When Jeb Hensarling (R., Texas), chairman of the House Financial Services Committee, grilled her earlier this year on this issue, Ms. Yellen responded feebly that the difference between the

fed-funds rate and the IOR rate at the time—12 basis points—was "really quite small." That's rather like trying to avoid a speeding ticket by claiming to have been speeding only a little bit. Pressed further, Ms. Yellen insisted that, despite what she'd said earlier, the Fed's rate settings were "legal and consistent with the [2006] act."

The law can only be stretched so far. Unless "general short-term rates" rise markedly, Congress can be expected to question the legality of any Fed rate increase. If it comes to that, Ms. Yellen will find it very hard to dissemble her way out of it.

Has the Fed any other choice but to stand pat or risk an ugly fight in Congress? It does. Instead of paying banks more to hoard reserves, it can tighten money the old fashioned way: by selling off some of its trillions of dollars in assets. Besides avoiding a brush with the law, selling reserves would mean taking a genuine step toward the "normalization" of policy that the Fed has long promised. That normalization would eventually allow the Fed to return to its older and more reliable—and perfectly legal—means of monetary control.

Whether events will warrant tightening before the year is out is anybody's guess. But if the Fed chooses to tighten, it should at least do it legally.

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