The financial crisis has changed the mechanics of monetary policy. When economic growth improves to the point that the Federal Reserve finally decides to increase short-term interest rates, it will need a new approach to do so. For the first time in history, to engineer the federal funds rate, the Federal Reserve will have to funnel billions of dollars of taxpayer money into financial institutions to borrow back the excess reserves it has injected into the banking system.

Before the crisis, the Federal Reserve engineered changes in short-term interest rates by buying and selling government bonds. The Fed would sell a government bond to a bank, which paid for the bond by drawing down reserves at the Fed. The bond sale reduced excess reserves in the banking system, which caused an increase in interest rates.

This tactic no longer works because, after quantitative easing, banks have nearly $2.8 trillion in reserves, including more than $2.7 trillion of excess reserves. With so many excess reserves in the system, the federal funds market — the market for buying and selling bank reserves — no longer sets the base short-term interest rate for the economy. The base rate is now set by the interest rate the Federal Reserve pays on bank reserves.

One alternative way the Fed can raise rates is by paying banks a higher interest rate on reserves. Since the start of the financial crisis, the Fed has been paying banks 25 basis points on their reserve balances. The interest rate on bank reserves sets a floor on short-term interest rates because banks are unwilling to make loans or purchase securities with their reserves unless they expect to earn more than 25 basis points after a suitable adjustment for risk. So if the Fed wants to raise the short-term interest rate to 50 basis...
points, it can simply raise the interest rate it pays on bank reserves to 50 basis points. Banks will adjust their short-term lending rates upwards accordingly.

A potential problem with this approach is political optics: it requires the Fed to channel billions of dollars of taxpayer money directly to banks. Prior to the financial crisis, the Fed paid banks nothing on their reserve balances. Paying 25 basis points on $2.8 trillion in reserves already requires the Fed to channel $7 billion of taxpayer funds into the banking system annually. If the Fed wanted to raise the federal funds rate to 4% — its historical average since 1985 — it would have to funnel about $110 billion into the banking system annually to pay interest on reserves. For perspective, consider that, in 2013, total bank profits in the U.S. were just shy of $152 billion and the Fed returned $79.6 billion in operating profits to the U.S. Treasury.

An alternative is to use a massive Fed reverse repurchase agreement program to soak up excess reserves. In this approach, the Fed would sell securities to institutions qualified to participate its pilot reverse repurchase agreement program — a group that includes more money market mutual funds than banks — and agree to buy the securities back the next day at an agreed-upon higher price. The interest rate on this transaction, the repo rate, is set by the difference in the sale and repurchase price for the collateral securities. The net effect is that the Fed borrows reserves from participating financial institutions to reduce excess reserves in the system.

But reverse repos would also pump billions of taxpayer dollars into financial institutions to coax markets to raise short-term interest rates. And in this alternative, Fed interest payments flow directly to banks and non-bank financial institutions.

Regardless of which policy the Fed adopts, it will have to make billions of dollars of additional interest payments to financial institutions — money that would have otherwise gone to the U.S. Treasury Department, reducing government budget deficits. Whether this new wrinkle will generate additional controversy for Fed policymakers remains to be seen. It is, however, an unavoidable consequence of the actions the Fed took to contain the economic damage from the financial crisis.

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