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Commentary by Jeff Kissel on Oil Prices and Normalization of Monetary Policy

Stephen D. Williamson, a respected economist and Vice President of the Federal Reserve Bank of St. Louis wrote a concise explanation of how the Fed will move to a more normal monetary policy.[1] He described it in three simple steps:

1. "Lift Off" – increasing borrowing rates, commencing in late 2015, provided the underlying economic data support the action.
2. End Reinvestment – by not replacing the unconventional interest bearing securities in the Fed's Balance Sheet when they mature
3. Shrink Balance Sheet - by not replacing both Treasuries and Mortgage Backed Securities as they mature, while holding out the possibility of the outright sale of these assets, if required.

An important feature of this process is that it will be transparent and measurable, once it actually begins. This means that the impact on the economy can, with reasonable accuracy be calculated and expressed in dollars relative to GDP.

The same is largely true for the price of oil as it rises and falls. Given that the recent cyclical reduction in oil prices has added approximately $1,000 per US household to annual disposable income and about 0.9% or nearly $2 trillion per year to US GDP [2] continued relative stability in the price of oil and the rest of the energy complex has the potential to moderate the impact of the Fed's return to a more normal monetary policy. In fact the impact of a $30/barrel decline on "Advanced Economies" for the years 2015 through 2017 can be seen in the table below:

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[1] *The Regional Economist; July 2015*

[2] *The Macroeconomic Impact of Lower Oil Prices;* Adrian Cooper ; Oxford Economics

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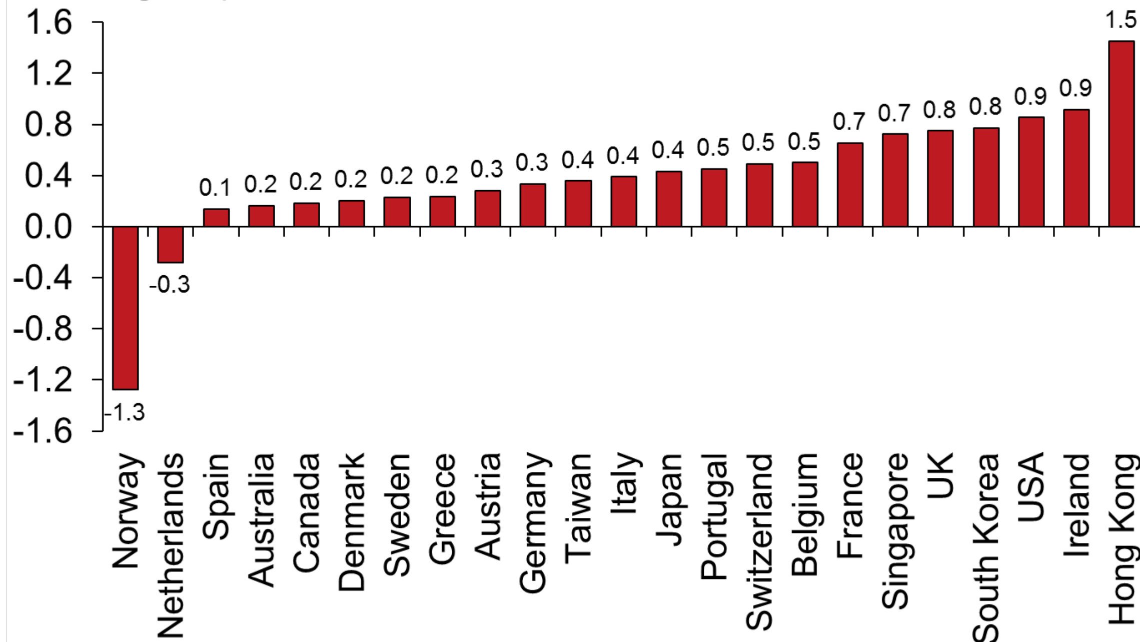

Accordingly, the lower cost of oil and related products in the energy complex, if sustained, can be used by the Fed and other central banks to dampen the impact of normalizing monetary policy. Since the Fed has announced that it's strategy will be data driven, the pace of normalization can be adjusted to reflect changes in the price of the energy complex, and likely will. The general consensus among economists, and the business community is that interest rates and monetary policy need to return to normal levels for the US and global economies to achieve a long term sustainable recovery.

Simply put, absent a major geo-political event, stable oil prices are a unique, and useful tool that will aid the Fed and their international counterparts in their effort to return the developed economies to a stable footing that will support healthier growth patterns, increasing employment, resulting in improved income distribution.