Statement before the United States House of Representatives

Committee on Oversight and Government Reform

Subcommittee on Regulatory Affairs

Hearing on How Federal Reserve Policies Add to Hard Times at the Pump

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Thank you, Chairman Jordan and other members of the subcommittee, for the opportunity to discuss monetary policy and the price of oil. I believe that it is an appropriate use of the subcommittee’s time to examine that connection. Indeed, both the net rise and the volatility of oil prices over the past nine months are partly a predictable byproduct of the Fed’s expansion of its balance sheet in its policy known as quantitative easing (QE). The Fed gambled that the benefits of the stimulus of QE to financial markets would offset the adverse effects of oil price developments. Whether that gamble pays off is yet to be proven.

QE was essentially designed to give a nudge to risk taking. Late last year, Fed officials announced they would purchase $600 billion of riskless Treasury securities over the period from November 2010 to June 2011. The hope was that investors would reinvest the proceeds in riskier assets. The resulting lift to equity prices and decline in corporate rates would, the theory runs, support economic expansion. The nudge to risk taking from QE seemed like mission accomplished for a time. Stock prices moved significantly higher and yield spreads narrowed once QE was seen as inevitable.

But not all the effects of QE have played out in financial markets. Since the Fed firmly signaled in August its intent to launch the latest round of QE, oil prices have risen from $76 to around $100 per barrel.
Why does the Fed’s balance sheet matter for oil prices? The producers of oil as well as other commodities typically sell their output in a worldwide market priced in U.S. dollars. Thus, they care about the current and expected future purchasing power of the dollar and how that will translate into goods and services back home. But QE has been associated with higher inflation and dollar depreciation, which combines to erode the purchasing power of the foreign producers of commodities. Thus, some of the rise in the nominal price of oil has been to catch up with that erosion.

Much more important in shaping near-term oil-price dynamics has been the nudge to investors from QE to move from safe to riskier investments. The commodity market has been one outlet for that reinvigorated search for yield. Investment flows into commodity-related vehicles has stepped up noticeably. This has been reinforced by the Fed’s policy of keeping short-term nominal interest rates near zero, which keeps it cheap to do some of that trading on borrowed funds. Such speculation neither produces nor consumes the commodity, so it should have no long lasting effect on prices. However, over short periods, it can fuel spasms of enthusiasm or angst that trigger wide swings in prices.

This increase in the price of oil and its heightened volatility poses three distinct problems for the Fed.
First, a rise in energy costs of one-third takes a distinct bite out of American households’ budgets, working to restrain spending in an economy already burdened by lingering balance-sheet problems from the 2008-2009 financial crisis. This probably explains why the expansion of real GDP thus far this year has fallen short of most analysts’ expectations. As of yet, however, the oil-price shock is not as large as those associated with severe economic dislocations of the past half century. For example, the recent rise in oil prices is small relative to the 150 percent hike from 2007 to 2008 that added to the headwinds creating recession.

Second, increases in the price of oil, as well as those of other commodities, has fueled an upsurge in inflation. Over the past six months, consumer price inflation has been running at a 5-3/4 percent annual pace and the dollar has depreciated on the foreign exchange market. But Fed officials had been worried for at least the past year that inflation might get too low relative to its mandate of price stability. Therefore, some lift from the prices of energy and other tradeables was probably not unwelcome to them. Further, they continue to believe that people are not likely to expect the prices of other goods or services to rise commensurately. If so, and if commodity prices do not continue to rise, then the level upshift in oil prices will pass out of inflation calculations in due course.

Third, in recent months, the world seems to be a much less safe place than usual, with unrest in the Middle East, uncertainties about Japanese energy supplies,
and changeable speculative flows in commodity markets. These combine to make the near-term balance between oil demand and supply volatile. They could, to the Fed’s regret, also make global investors more skittish and undercut some of the benefit in financial markets attributable to QE.

On net, it is likely that the economy-wide effects of the energy shock are unpleasant but not derailing to expansion. But this is a gamble, and one Fed officials must apparently have accepted when they decided to launch QE. We will live with the consequences of that judgment in coming quarters.
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Vincent Reinhart, a former director of the Federal Reserve Board's Division of Monetary Affairs, joined AEI in 2008 after working on domestic and international aspects of U.S. monetary policy at the Fed for more than two decades. He held a number of senior positions in the Divisions of Monetary Affairs and International Finance and served for the last six years of his Federal Reserve career as secretary and economist of the Federal Open Market Committee. Mr. Reinhart worked on topics as varied as economic bubbles and the conduct of monetary policy, auctions of U.S. Treasury securities, alternative strategies for monetary policy, and the efficient communication of monetary policy decisions. At AEI, he has continued his work on all of the above in addition to research on key economic variables before and after adverse global and country-specific shocks, policy mistakes leading to the 2007-09 financial meltdown, and the implementation and impact of quantitative easing.

Personal Information

Birth date: August 20, 1957.
Married to Carmen M. Reinhart, one child (William).
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Professional Positions

Senior Adviser, Board of Governors of the Federal Reserve System, August 2007 – September 2007

Director, Division of Monetary Affairs, Board of Governors of the Federal Reserve System


Deputy Director, Division of International Finance
Deputy Associate Director, Division of Monetary Affairs, 1998–1999.

Assistant Director, Division of Monetary Affairs, 1994–1998.


Economist, Banking and Money Market Analysis Section, Division of Monetary Affairs, 1988–1990.


**Other Professional Activities**

Member, OECD Ad Hoc Group of High Level Monetary Experts.

Member, Working Party on Domestic Monetary Policy, Bank of International Settlements.

Regular lecturer, IMF Institute, International Monetary Fund, Washington D.C.

Regular lecturer, Federal Reserve Bank of New York Central Banking Seminar, New York, NY.

Occasional lecturer, University of Maryland, College Park.

Visiting scholar, Banco de España, Madrid, Spain, October 2002.

Member, Committee on the Global Financial System working group on a post mortem of the events in financial markets of Autumn 1998, 1999.


Visiting scholar, Banco de la Republica, Bogotá, Colombia, October 1997.


Visiting scholar, Bank of Israel, Tel Aviv, October 1994.
Member, Euro Currency Standing Committee working group on derivatives and the conduct of monetary policy, 1994.


Education

M.Phil., Economics, Columbia University, 1982

M.A. Economics, Columbia University, 1980

B.S. Fordham University, 1978, summa cum laude

Honors

Special Achievement Award, Board of Governors of the Federal Reserve System, 1992

President’s Fellow, Columbia University, 1980 1983

University Fellow, Columbia University 1978 1979

Recent Presentations


Recent Publications in Journals
“Pride Goes Before a Fall,” (with Carmen M. Reinhart), Cato Journal (forthcoming).


“When the North Last Headed South: Revisiting the 1930s,” (with Carmen M. Reinhart), Brookings Papers on Economic Activity, No. 2 (2009), 251-275.


Recent Chapters in Books


Committee on Oversight and Government Reform
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Name: Vincent Reinhart

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   None

2. Please list any entity you are testifying on behalf of and briefly describe your relationship with these entities.
   None

3. Please list any federal grants or contracts (including subgrants or subcontracts) received since October 1, 2008, by the entity(ies) you listed above. Include the source and amount of each grant or contract.
   None

I certify that the above information is true and correct.
Signature: Vincent Reinhart
Date: 5/23/2011