Petronomics and the Fed[*]

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Broadly speaking, there are two things the Federal Open Market Committee (FOMC) can do in response to a dramatic change in oil prices. Given the Federal Reserve Board's dual mandate to maintain an environment of price stability and maximum employment, one of these options is definitely bad and one option is fundamentally appropriate.[1]

In keeping with the dismal aura of economics, let's start with the definitely bad option: namely, the active stabilization of the possible decline in real activity associated with a sharp rise in oil prices. Typically this would involve the FOMC easing monetary policy in the face of a large rise in oil prices. There are numerous reasons why this approach is generally wrong-headed. First, most oil price "shocks" are temporary, reversing themselves within a three to six month time period. Indeed, in the last 10 years or more, most positive increases in oil prices on the spot market have typically been combined with an unchanged oil futures price. Such price responses indicate that the oil price changes are temporary. And the FOMC has little ability, and even less success, in stabilizing the short-lived consequences of such shocks to real economic activity.

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[1] Of course, the FOMC could completely ignore a large increase in the price of oil. This, however, is somewhat unlikely, as even in a passive Taylor rule approach to policy, some of the fundamental determinants of policy such as output (perhaps falling) and measured inflation (perhaps rising) would fluctuate as the price of oil rose, necessitating at least some change in policy.

Second, even if the data suggest that the change in oil prices is permanent (e.g. a similar rise in the spot and future prices of oil), the reasons for such a change are either that there was a permanent decline in the world supply of oil or a permanent rise in the world demand for oil. In the latter case, a rise in the world demand for oil is typically driven by a rise in world wide economic activity, which is certainly not a cause for the FOMC to ease. In the former case, while supply disruptions in oil would likely lead to disruptions in U.S. economic activity, it would also likely bring forth an atmosphere where firms would want to pass on the rise in their costs through setting higher prices, which would lead to upward pressure on the U.S. price level. Validating a rising price-level environment with a monetary policy of easing is a ticket back to the stagflation of 1970's, replete with leisure suits and disco music.

Now let's talk about the correct option: namely, adopting an FOMC policy that quickly reverses and extinguishes any effect of large oil price changes on inflation and inflation expectations. There is reason to believe that Federal Reserve Chairman designate Ben Bernanke fundamentally understands this notion. In remarks to the Eastern Economics Association in 2004, then Governor Bernanke stated:

> *For example, significant movements in the price of oil and other commodities continued to occur after 1984. However, in a low-inflation environment, with stable inflation expectations and a general perception that firms do not have pricing power, commodity price shocks are not passed into final goods prices to nearly the same degree as in a looser monetary environment. As a result, a change in commodity prices of a given size shows up as a smaller shock to output and consumer prices today than it would have in the earlier period.* Bernanke [2004].[2]

2 Ben S. Bernanke, The Great Moderation, Remarks at the Eastern Economic Association, Washington, DC, February 20, 2004. http://www.federalreserve.gov/boarddocs/speeches/2004/20040220/default.htm

One can only hope that an FOMC chaired by Bernanke and rooted in the intellectual and policy discipline of inflation targeting will implement a policy to deliver this low-inflation environment.

There is some reason to believe that such a policy is underway. For instance, long term interest rates, an indicator of long term inflation expectations, have recently risen much less than measures of broad inflation. And surveys of inflation expectations, as well as those inherent in indexed securities, also indicate that the current rise in measured inflation is likely to be temporary.

Nevertheless, pundits and policymakers who continually argue that the high oil price environment will lead the FOMC to potentially temper its current monetary policy strategy are (hopefully!) misguided. With real output growth at historical levels, and broad measures of inflation above longer run inflation expectations, the fundamentals of good monetary policy suggest that containing any inflation consequences from higher oil prices remains a top priority.