

# The Economy in Perspective

*“We must proceed with our own energy development. Exploitation of domestic petroleum and natural gas potentialities, along with nuclear, solar, geothermal, and non-fossil fuels is vital. We will never again permit any foreign nation to have Uncle Sam over a barrel of oil.”*

—Vice President Gerald R. Ford, 1974

The monetary policy situation now facing the FOMC is a textbook classic of advanced macroeconomics courses: How should the monetary authority respond to an adverse energy shock? A reduced supply of oil to the United States can be expected to raise oil’s price and to slow economic activity. Central banks want to do all they can to cushion the economy against the shock to growth by pursuing an easier monetary policy, but concerns about rising inflation can pull policymakers in the opposite direction. How does the savvy central bank navigate such troubled waters?

Credibility is crucial. If the public believes the central bank is committed to keeping inflation within a known range, then their wage- and price-setting decisions will probably be consistent with that range. If people fear the central bank will allow inflation to escalate over time, their actions today will be predicated on that expectation. For example, employees might demand higher wages or companies might ask higher prices for their goods and services. Nominal interest rates would probably rise as savers seek protection against erosion in the purchasing power of the funds they lend. The dollar’s foreign exchange value would tend to depreciate: Dollar purchasers would want to get more dollars for each unit of their currency because they expect the dollar’s purchasing power to shrink. But to the extent that people expect the central bank to preserve price stability over time, these actions will be muted or nonexistent.

Can a central bank ignore the economic slowdown that would probably accompany energy price shocks, especially if the bank has a mandate to support economic growth? The key insight here is that a large energy price increase really represents a reduction in supply that cannot be offset merely by printing more money. The economy’s necessary adjustment to the supply reduction could manifest itself as a period of sub-par growth. Ordinarily, the central bank would reduce its policy interest rate

path in anticipation of sagging economic activity, especially if the policy adjustment would not stimulate inflation expectations. In this way, the central bank could cushion the economy against the energy price shock.

Although the prescription is straightforward, implementing it is complicated because the policy path will depend on the central bank’s credibility and the inflation dynamics already at work when energy shocks hit the economy. For example, the FOMC had been pursuing a very accommodative monetary policy when energy shocks began to hit the economy in 2003. Although the shocks undoubtedly trimmed its rate, the expansion continued at a solid pace nonetheless. As resource slack diminished, the FOMC began reducing the degree of policy accommodation and has continued to do so since last summer.

Under perfect conditions, the FOMC would finish removing its policy accommodation just as the economy reaches its growth potential and with little chance of core inflation accelerating. This could still happen, but the energy price shocks are obscuring the true inflation picture. Has monetary policy already been so accommodative that even core inflation has begun creeping upward? If so, should the policy path tilt up as well? Or does weakness in various economic data signal that energy price shocks are taking a greater toll and the measured pace of policy actions is nearly at an end?

As this drama has played out, the public has displayed a great deal of confidence in the long-term inflation trend. Although people have correctly anticipated the rise in short-term inflation, they maintain their belief that the inflation rate will drop once the energy price shocks work their way through the economy. Consistent with that perspective, people also seem to expect the first quarter’s economic lull to be temporary.

The April labor market report contained hopeful news: Besides indicating that April job growth exceeded analysts’ expectations by about 100,000, the report also revised up the employment levels for February and March by nearly 100,000 in total. However, that optimism immediately translated into caution about the future course of short-term interest rates. In this environment, it seems, good economic news is welcome, but only up to a point.

## Answers to April crossword puzzle

**Across:** 1. DEFICIT; 3. COLA; 4. MINIMUM; 6. SARBOX; 7. MEASURED; 8. CAPITAL; 11. CHINA; 12. OFFSHORE; 13. PERSONAL; 14. GSE; 15. TEXTILES; 16. AIG; 17. BERNANKE

**Down:** 2. TIPS; 3. CARTEL; 5. INSURANCE; 9. INFLATION; 10. CURRENT; 11. CBOT; 13. PAYGO