Monetary Policy Responses to Oil Price Fluctuations

Bodenstein-Guerrieri-Kilian

Discussion

by

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[1] **The views expressed in this discussion don't necessarily reflect the views of the ECB.**

Outline

- Summary of the paper
- Comments
- Conclusions

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- Main message: The (optimal) monetary policy response to oil-price changes depends on the source of shocks
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- Estimated "Taylor" rules are compared to optimized instrument rules
- Evaluation metrics: Welfare of the representative household
  - Optimal rule appears to fully stabilize the output gap
  - Welfare losses under estimated rule are huge (up to 3% of steady-state consumption – scaling factor?)
  - Non-cooperative policy game shows large gains from cooperation (up to 0.11% of st.st. consumption)

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Comment 1: Core inflation vs. Headline inflation

- Central bankers are concerned about two aspects of inflation: Its volatility and its medium- to long-run level
- In good part the policy debate focuses on a different point than that discussed in the paper
  - From this debate, it appears that having a target for headline (CPI) inflation is a good thing
  - Then the question is: which measure of inflation is a good indicator of future developments in the target variable? (e.g. M. Lenza and L. Reichlin on Voxeu, 2011): which index is a good guide for policy?
- The paper points to a deeper issue – which inflation measure should we target?

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Comment 2: "No two shocks induce the same policy response"

- This point needs some more clarification
  - This is a very general statement that holds even without oil.
  - In practice all policy decisions depend on a large set of considerations. Hence, it is true also in practice that not all oil-price increases are seen in the same way.
  - Interestingly, in the model the policy rule is invariant to the source of the shocks: so the "response" to inflation and output-gap is invariant to shocks.

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- In the paper the optimal policy maximizes households' welfare by choosing the response parameters of the policy rate to output gap and inflation
- Alternatively one could derive the optimal (Ramsey) allocation – i.e. not constrained by a simple interest rule.
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Comment 4: Non-cooperative policy game

- An alternative set-up – which I would prefer – would have two large countries plus a small oil-exporter
- When it comes to policy interactions a game, say between EA and US would be very interesting.
- In particular, for the EA, oil-price fluctuations and exchange rate movements interact in a crucial way.
- Which kind of policy spillovers do the shocks produce? All negative? All positive?
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- Often (fiscal) policymakers have the temptation to reduce taxes/increase subsidies on gasoline etc. in response to large oil-price increases (e.g. Jospin 2000, currently some regions in Italy etc.).
- I would find interesting to see how this further policy instruments would modify the monetary policy task
- Also, if fiscal authorities have stabilization objectives, the monetary policy problem could change significantly
- Finally, how would the best response to oil-price fluctuations if the CB had a more narrow objective: e.g. medium-term stability of some measure of headline inflation?

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Conclusions

- Nice paper!: Simply looking at oil prices gives no guidance to appropriate policy responses.
- Gains from monetary policy cooperation can be large.
- Losses from sub-optimal (estimated) policies appear to be sizable.
- With a few more clarifications this will become a reference paper in the field.