

MONETARY POLICY AND THE DECLINE IN OIL PRICES
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In recent weeks, financial market sentiment has come to the single-minded conclusion that the bond market version of Nirvana has finally arrived. It is widely believed that interest rates will remain low, perhaps even fall lower, in the foreseeable future. This view arises, in large part, from the current disinflationary effects of lower oil prices on the prices of goods and services. It has been reinforced by recent arguments, expectations and deep desires that the Fed should and will ease monetary policy.

I am tempted to say simply that the market is wrong. But having been a professional participant at one time, I have a tremendous respect for the ability of markets to discount future developments. On the other hand, when powerful trends like we have seen recently develop, there can be a tendency for markets to become overextended--for participants to get so caught up in the psychology that triggered the move, that other fundamental considerations are ignored for a time. I believe this could be happening now in interpreting the effects of oil price declines on the economy and in evaluating how monetary policy should respond. Despite what you may have heard or may even believe, inflation is not dead. Moreover, arguments that the Fed should further ease policy at the present time are, in my judgment, simply ill-advised.

To see why these current market views may be defective, let us consider the answers to a couple of general questions. The first one is "How will the lower oil prices affect the economy?" Oil prices have

fallen by nearly half since the end of 1985. Gasoline prices have already tumbled; prices of other, competing sources of energy, such as natural gas and coal, will fall as well. These energy price reductions will work their way throughout the economy's production processes, ultimately affecting prices of nearly all goods and services.

To be sure, not all firms and industries will benefit equally. We have heard plenty about those who have been hurt--domestic oil producers, firms that manufacture drilling equipment and so on. On the other hand, industries that rely heavily on energy as an input, like agriculture, basic metals, transportation, paper and chemicals, will benefit relatively more than others.

Of course, it takes a little time for the full effects of lower energy prices to be realized. Therefore, while the largest declines in producer prices are likely behind us already, the broader measures of prices, such as the consumer price index and the GNP deflator, will continue to be influenced throughout the rest of the year and next year as well. For example, our analysis indicates the GNP deflator will rise about 1.5 percent less this year and in the first half of 1987 than it otherwise would have, with the largest part of this effect concentrated in the last half of this year. Overall, prices will be about 2-1/2 percent lower by the end of next year than they would have been otherwise.

We know why these price level changes occur. When energy becomes relatively cheaper to use, producers alter methods of production. As more energy is used per unit of capital or per unit of labor, output rises. In some cases, resources that were used previously to economize

on oil and energy use now become more efficiently employed elsewhere. In other cases, plant and equipment that was previously idle, or used only marginally, now can be profitably employed more intensively.

Lower energy prices also have other beneficial effects on the economy. When costs of operating equipment and structures fall, producers invest more in new plant and equipment. Again this process takes time, perhaps three years or more. While it goes on, the faster pace of capital accumulation will further improve productivity.

Because we end up, in effect, with more goods chasing the same quantity of money, prices naturally are lower than they otherwise would be. Obviously, the inflation rate temporarily will be lower than it would be otherwise. As a result, interest rates, especially short-term interest rates, naturally decline--for a time. This, then, is the core of truth that underlies current market perceptions about the effect of lower energy prices on inflation.

The basic problem with the typical bond market perception is one of faulty extrapolation. The announced declines in producer and consumer prices in February and March of this year appear to have been extrapolated into the indefinite future as far as the eye can see. This could be a serious error. The process of output and price adjustment I just described occurs fairly quickly. We have ample experience with oil price shocks to know that, when major energy price jumps occur, inflation will jump temporarily in the same direction. However, inflation soon returns to the rate determined by more permanent fundamental forces.

One such fundamental force, the rapid pace of money growth over the past several years, suggests that the longer-run direction of inflation is upward. Thus, any decline in inflation brought about by lower energy prices will be temporary; inflation can be expected to return to the course it was previously on. What might that course be? One indication is that inflation measured by the CPI or PPI had been running at about a 5 percent annual rate in the four months up to January of this year. And the most recent producer price index for finished goods, although reported down 1.1 percent for March, reflected an increase of 0.6 percent in prices of goods excluding food and energy--more than 7 percent inflation at an annual rate.

There is another important temporary influence on prices besides the drop in energy prices that is working in the opposite direction. The value of the dollar has fallen 30 percent over the past year against other currencies, a sharp turnaround from its 15 percent per year average appreciation from 1980 to early 1985. According to some estimates, the prior rise in the dollar's value temporarily reduced inflation by about 1.5 percent last year. With the sharp drop in the dollar's value, we can expect the opposite effect on inflation this year. Imported goods cost more, and domestic producers of import-competing goods have room to increase prices as well. The effect of recent exchange rate movements alone in boosting inflation could largely offset the downward push from the oil price decline.

Thus, given the underlying inflationary pressures and the offsetting effects of a lower dollar, inflation for this year and next is likely to be about the same as, or possibly somewhat higher, than last year. During

1985, broad measures of prices rose 3 to 4 percent and producer prices rose about 2 percent. The upward momentum of the underlying forces of inflation will still dominate the broad measures this year. Producer prices are likely to rise more slowly in 1986 only because the decline in oil prices has a greater immediate effect on this measure of prices.

The oil price decline, then, at best, has postponed a deterioration in price performance. But looking out to 1987, the prospects for renewed growth of output and employment carry with them a strengthening in domestic demand for labor and accelerating wage and price pressures. Likewise, the oil-induced faster growth of output will increase the demand for credit, especially for larger plant, equipment and inventory financing, putting further upward pressure on interest rates.

Moreover, over the next year, most analysts are looking for a significant improvement in the U.S. trade deficit. The counterpart of this improvement, however, is a reduced supply of credit from abroad. Thus, in 1987, when cyclical pressures and pressures from past monetary stimulus may already be causing acceleration in inflation and higher interest rates, we could also be facing an imbalance in the supply and demand for savings. Against this backdrop, it is difficult to justify policy actions now that could worsen the inflation and interest rate outlook for 1987.

But many analysts and policymakers ignore these prospects in asking "What should the Fed do?" They strongly suggest, even urge, that the Fed should ease policy in light of current developments. The rationale, generously interpreted, is that, because inflation is "licked" and the public's inflation expectations are dead, the Fed can safely ignore it, and use policy to further stimulate the economy.

I don't know whether I should be amazed or amused by such arguments. I do know that there is a group of analysts that, no matter what political or economic developments arise, will inevitably argue that a strong case exists for easing monetary policy. I am not surprised that they should rear their heads when oil prices decline. After all, many of these people argued in 1974 and 1979, when oil prices rose, that the Fed should ease then as well.

Sharp changes in oil prices always provide a dilemma for policy-makers, although the choices are more pleasing when oil prices fall than when they rise. Falling oil prices make easing look appealing because its inflationary consequences are hidden for awhile. Tightening, however, is also appealing because its adverse short-run influence on output and employment growth is hidden by the positive real effects of the oil price decline. The choice between tightening or easing in such circumstances depends upon your policy outlook for inflation. A tighter policy allows the beneficial short-term inflation effect of the oil price decline to be extended into the future. An easier policy temporarily reinforces the positive effects of the oil price decline on output and employment, but worsens the long-term inflation outlook.

While the oil price decline temporarily lessens inflation concerns, fundamental forces indicate the possibility of higher inflation and interest rates in 1987 and beyond. These upward trends will look much worse as the oil price effect wears off. Instead of a moderate and steady climb, the oil price effect will temporarily slow inflation now, but inflation will jump back up sharply down the road. Easier money growth this year will worsen the extent of that surge, and it will worsen the long-term inflation problem we will face at that time.

Finally, let me emphasize that there are substantial differences in the timing and the nature of the effects of oil price shocks and monetary policy actions. Oil prices affect the economy relatively quickly; when the smoke clears, however, the future growth rates of prices, output and employment are hardly affected at all. The effects of monetary policy actions, however, build slowly, gradually and, for spending and inflation, permanently.

This divergence between the timing and nature of these effects argues strongly against the further easing of Fed policy at the current time. Most of the impact of the oil price decline will long be over by the time that the effects of faster or slower growth in money stock would be fully realized. Responding to oil price shocks with monetary policy would sharply destabilize the pace of money and credit growth. Easing money growth now would yield no lasting gains, but would permanently worsen the outlook for future inflation.

In the 1970s, most monetary policymakers around the world wisely resisted strong calls for monetary easing that arose due to the temporary effects of oil price increases. This time around, we are not likely to hear the logical counterpart, calls for monetary tightening. Certainly, the case for easing now, as some have recently demanded, is far flimsier than it was in the 70s. That won't keep such demands from continuing; however, I am hopeful that now, as then, these demands will be ignored.