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THE EFFECT OF ENERGY PRICES ON MONETARY POLICY

Abstract:

Since beginning of the 1990s an increasing number of emerging countries have adopted inflation targeting regimes. The inflation targeting strategy should include a high degree of flexibility to external shocks for monetary authorities to maintain credibility. Thus, the external energy prices shock adjustment should remain outside the objectives of monetary policy and the central bank itself should focus only on fighting inflation. In this sense, the monetary authorities should mostly ignore the externally induced energy price shock and react only to energy price changes only to the extent they protrude into the core inflation. However, many open economies import a relatively larger share of their domestic consumption than the largest economies monetary policy analysis usually focuses on. The energy price shock associated with a large pass-through leads to a much larger effect on the inflation rate than a large country would experience in the same situation. In the presence of large balance of payments imbalances allowing for volatility in small open economies is rarely optimal, as the risk of sudden swings of capital flows in response to external disturbances is higher than assumed before the financial crisis. In this sense, the domestic goals of monetary policy may stand in a significant conflict with the objectives of the inflation targeting regime.

The article discusses the results of an empirical analysis of monetary policy reaction to energy prices. We test the hypothesis that energy prices are linked with a long-term co-integrating relationship to the monetary policy stance. The study uses monthly data for the years 2000-2015 for 21 countries. Due to the heterogeneity of the expected adjustments in the short and long run and unobservable cross-correlation between the units the three heterogeneous panel estimators are used - namely Pooled Mean Group (PMG, Pesaran et al., 1999), Augmented Mean Group (AMG, Bond and Eberhardt, 2009; Eberhardt and Teal, 2010), and Mean Group (MG, Pesaran et al., 1995)- and compared with standard Fixed Effects model. Model estimations were preceded by tests of stationarity, cross sectional dependence, and second generation panel cointegration.

We find that although in theory the implications for monetary policy are ambiguous, they are not. A significant degree of accommodation to energy prices occurs that is not related to output gap, food prices or the core inflation. We therefore conclude that the recent track record of monetary policy is to reduce the energy price impulse.

Keywords:

panel cointegration, monetary policy, interest rates

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