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How Should Monetary Policy Respond to Changes in the Relative Price of Oil? Considering Supply and Demand Shocks

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PII: S0165-1889(14)00083-9
DOI: http://dx.doi.org/10.1016/j.jedc.2014.04.002
Reference: DYNCON2982

To appear in: *Journal of Economic Dynamics & Control*

Received date: 7 June 2010
Revised date: 6 March 2013
Accepted date: 30 March 2014

Cite this article as: Michael Plantep, How Should Monetary Policy Respond to Changes in the Relative Price of Oil? Considering Supply and Demand Shocks, *Journal of Economic Dynamics & Control*, http://dx.doi.org/10.1016/j.jedc.2014.04.002

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How Should Monetary Policy Respond to Changes in the Relative Price of Oil? Considering Supply and Demand Shocks.

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Abstract

This paper examines optimal monetary policy in a New Keynesian model where supply and demand shocks affect the price of oil. Optimal policy fully stabilizes core inflation when wages are flexible. The nominal rate rises (falls) in response to the demand (supply) shock. With sticky wages core inflation falls (rises) in response to the demand (supply) shock. Impulse response functions from a VAR estimated with post-1986 U.S. data show minimal movement in core inflation in response to both shocks. The federal funds rate rises (falls) in response to the demand (supply) shock, consistent with the predictions from the theoretical model for policy that stabilizes core inflation.
JEL Classifications: E31, E52, Q43

Keywords: oil prices, optimal monetary policy, inflation, interest rates

Accepted manuscript

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This is a revised version of my job market paper that previously circulated as a CAEPR working paper titled "How Should Monetary Policy Respond to Exogenous Changes in the Relative Price of Oil?" For many helpful comments and suggestions I would like to thank the editor, two anonymous referees, my thesis advisors Edward Buffie, Eric Leeper, Brian Peterson, and Todd Walker, as well as Anthony Landry, Mine Yucel, Anthony Murphy, and seminar participants at the 2012 Midwest Macro Meetings and the Dallas Fed brownbag seminar. In addition, I am grateful for comments received from various people during my stay at the Riksbank in the summer of 2008 and the Board of Governors in the fall of 2008, including Lars Svensson and Christopher Erceg. All errors remain my own. As always, the results and my opinions regarding these results are mine alone and do not necessarily reflect the official views of the Federal Reserve Bank of Dallas nor the Federal Reserve System as a whole.

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