Letters to the Editor
The Financial Times

Sir,

You report (FT Wednesday, September 7, 2005) the Chief Economist of the OECD, Mr. Jean-Philippe Cotis, as stating that “As long as inflation expectations remain well-anchored, higher oil prices also seem to call for lower interest rates than would otherwise have been the case”. That statement is false, or at the very least needs to be heavily qualified, regardless of whether central banks target inflation or both inflation and the output gap – the difference between actual and potential output.

The increase in the real price of oil lowers potential output, with the magnitude and duration of the decline depending on the magnitude and duration of the oil price increase. The proper monetary policy response to a reduction in potential output is temporarily higher short term interest rates. An increase in the real price of oil also impacts on effective demand and actual output. The impact is positive for a net exporter of oil and closely related energy inputs, negative for a net importer.

The UK is a small net importer of oil and natural gas. The effect of an increase in the price of oil on demand is therefore negative but small - in all likelihood smaller than the negative effect on output. A temporary tightening of monetary policy is therefore called for. The Eurozone is a somewhat larger net importer of oil and natural gas. The case for monetary tightening there is therefore weaker than in the UK, and it is even possible that a temporary relaxation of monetary policy would be called for. In Japan, which imports all of its oil and natural gas requirements, a temporary easing of monetary policy is appropriate.

The US is a special case. The reduction in potential output caused by the increase in the price of oil is larger than in Europe and Japan because of the greater energy-intensity of US production. Hurricane Katrina also damaged US productive potential directly. However, the US is a large net oil importer. The appropriate monetary response to the oil price increase and the physical destruction caused by Katrina is therefore ambiguous. Adding in the likely negative confidence effects on US demand caused by the spectacular failure of US government at all levels, before and following Katrina, could well tip the balance towards a case for temporary monetary relaxation in the US. However, the behaviour of the US stock market suggests that the confidence penny may not (yet) have dropped.

Yours sincerely,

Willem H. Buiter

Professor of European Political Economy, European Institute, London School of Economics and Political Science
e-mail: w.buiter@lse.ac.uk