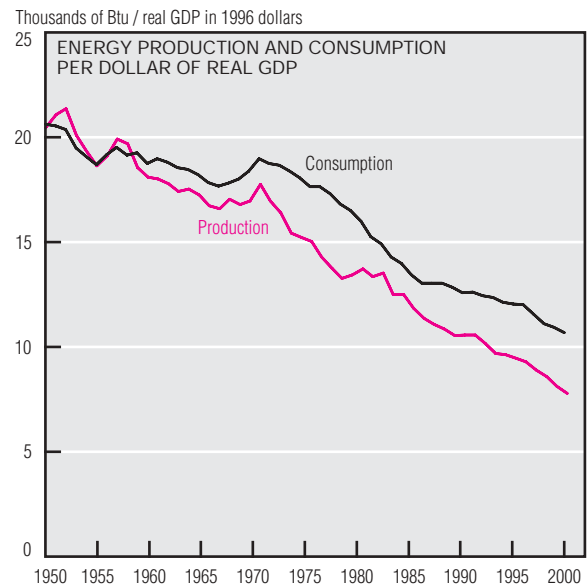
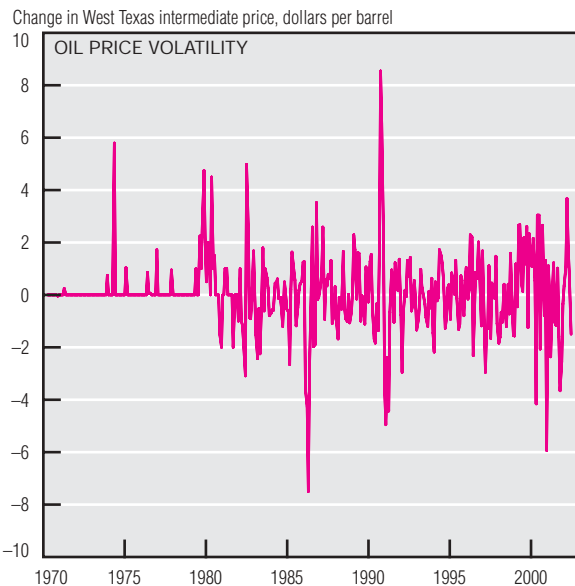
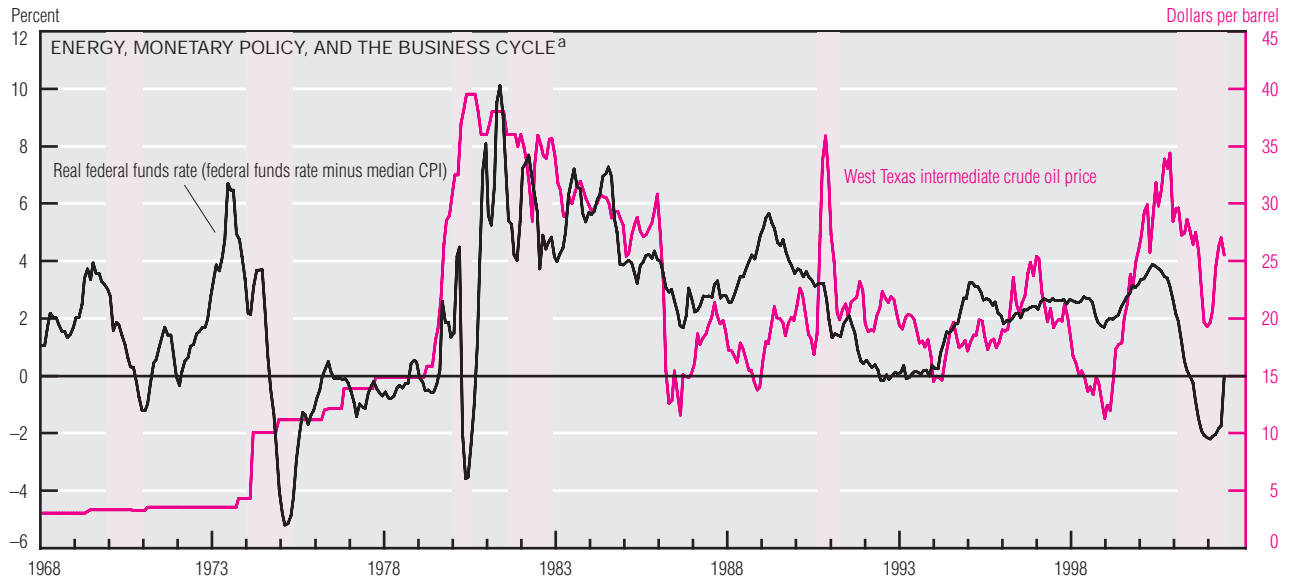


# Energy, Monetary Policy, and the Business Cycle



a. Shaded areas indicate recessions.

SOURCES: U.S. Department of Energy; Board of Governors of the Federal Reserve System; Federal Reserve Bank of Cleveland; and *Wall Street Journal*.

With the economy moving toward recovery, price pressures will eventually build, and the Federal Open Market Committee will need to focus more keenly on price stability. Threading policy between recovery and price stability will be especially difficult if oil prices remain high and volatile.

Oil prices have spiked before nearly every U.S. recession since World War II, including the recent slowdown. Many economists have suggested, however, that oil costs alone are too small relative to output to explain such severe business-cycle responses.

They contend that imperfections in the adjustment process or some other mechanisms—primarily monetary policy—leverage oil price shocks into economic downturns. Indeed, an increase in the real federal funds rate—the observed funds rate minus the median CPI inflation rate—also has preceded nearly every recession.

Economic studies, however, indicate that the economic impact of oil price shocks has waned since the early 1980s. Although oil price increases preceded the downturns of 1990–91 and 2001–02, these recessions were

especially mild. Many economists point out that the U.S. economy has become much less dependent on oil. We now use about half as much energy to produce a unit of GDP as we did in 1970. Many others, however, attribute the post-1980 break between oil prices and economic activity to a change in the nature of monetary policy. The Federal Reserve has rebuilt its reputation for price stability, with the result that inflation expectations no longer parallel energy price patterns closely. Price credibility has real value.