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Headline: Managing an Energy Shock: Fiscal and Monetary Policy

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Summary: When MPCs [marginal propensities to consume] are realistically large and the elasticity of substitution between energy and domestic goods is realistically low, there is a direct link between high energy prices and aggregate demand: increases in energy prices depress real incomes and cause a recession, even if the central bank does not tighten monetary policy. When nominal and real wage rigidities are both present, imported energy inflation can spill over to wage inflation through a wage-price spiral; this, however, does not mitigate the decline in real wages.. Fiscal policy, especially energy price subsidies, can isolate individual energy importers from the shock, but it raises world energy demand and prices, imposing large negative externalities on other economies. Related: The Many Channels Of Firms' Adjustments To Energy Shocks: Evidence From France and Europe: Well-Positioned To Get Through Next Winter Without Major Gas Shortages and How Europe is Decoupling from Russian Energy

Primary Topic: Energy

Topics: Academic paper, Business Cycle, Energy, GDP, Weekly

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