

Session 9:

Impact of Oil Prices on Central Bank Monetary Policy and Reserves Management

Oil Prices and Monetary Policy: What the Evidence Says, and What Makes This Episode Different

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What the Evidence Says, and What Makes This Episode Different

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The textbook answer

An oil shock is a relative price change, not an inflation process

- Raises headline inflation directly; raises core indirectly through production costs
- Lowers real incomes and demand — a supply shock moves output and prices in opposite directions
- Standard prescription: look through first-round effects, respond only to second-round effects



Three findings that qualify the textbook

The evidence is more conditional than the rule suggests

1. **The source of the shock matters.** Supply-driven and demand-driven oil shocks have different macroeconomic effects (Kilian 2009)
2. **The response has weakened over time** — lower oil intensity, more flexible labor markets, and better-anchored expectations (Blanchard and Galí 2010)
3. **Over-tightening can cost more than the shock.** Part of the output loss after historical oil shocks reflected the policy response, not the shock itself (Bernanke, Gertler and Watson 1997; debated by Hamilton and Herrera 2004)

The conditions are not the same everywhere

Second-round effects depend on structure and credibility

- Larger and more persistent inflation responses where **food and fuel weigh more heavily in the consumption basket**, inflation is already high and expectations are **less well anchored**, and central banks are **less independent** (Gelos and Ustyugova 2017)
 - When these conditions hold, under-reaction of interest rates can cost more than over-tightening.
- Exchange rate pass-through is **state-dependent** — higher when inflation is already high, lower under credible inflation targeting (Carrière-Swallow et al. 2021; Choudhri and Hakura 2006)
- Net importer or exporter changes the sign of the terms-of-trade effect entirely

This episode: don't look only at Brent

The disruption moved downstream

- Since late February: Brent (spot) **+70%**, gasoline **+77%**, gasoil **+90%**, jet fuel **+80%**
- Refined-product trade has fewer alternative routes than crude; conflict outages constrained the Gulf grades Asian refiners use for diesel and jet fuel
- **Implication:** fuel costs can stay high even as crude eases — asymmetry well documented in the "rockets and feathers" literature (Borenstein, Cameron and Gilbert 1997)



Much of the shock has not yet reached consumers

The pipeline is full

- Regional producer price inflation **nearly doubled**, from 8.7% in February to 16.5% in June
- New ADB estimates across 27 regional economies: **~23% of a PPI move reaches CPI within 3 months, ~47% after two years**
- Heterogeneity is large — South Asia: **54% at 3 months, 69% at 2 years**
- Headline inflation eased to 3.7% in July, but picked up again to 4.0% in August and **7.8% excluding the PRC**

And a second supply shock is arriving

El Niño compounds the energy shock

- Very strong event, forecast to peak around November and persist into 2027
- Compounds through: fertilizer costs to yields; hydropower shortfalls to fuel and LNG demand; heat to cooling demand
- Historically raises inflation by **0.1 to 1 percentage point**, with the response scaled to the food weight in the CPI (Cashin, Mohaddes and Raissi 2015)
- Effects arrive with a lag (**2027, not 2026**), and are heterogenous (Fernando and Ozden, forthcoming):
 - The inflationary effects in emerging economies are larger and more persistent
 - Economies that experience drying effects under El Niño see the largest rise in inflation

How central banks have actually responded

Mostly holding, with divergence ahead

- Around three-quarters of policy decisions in Q2 2026 were holds; **85% in July–September**
- Hikes peaked at **20% of decisions in Q2**, as energy prices surged, then faded
- Expected paths diverge sharply through end-2026 — easing in parts of Central Asia, further tightening elsewhere
- Broad-based easing expected to resume in 2027



The constraint that is less discussed

High debt weakens what monetary policy can do

New ADB analysis, up to 85 economies, three decades:

- Fiscal pressures pull policy rates away from what macro conditions warrant — **strongest in emerging economies and where public debt is high**
- Elevated public and private debt **mute the transmission** of policy rates to output and bond yields
- Central bank independence helps, but **cannot fully offset** the effect of high debt

Implications, and questions for the panel

For monetary policy

- Distinguish the relative price move from the inflation process — but check whether the conditions for looking through actually hold
- Watch producer prices and import costs, not just headline CPI
- Communication is doing more work than the policy rate

For reserves management

- Higher import bills draw down buffers in energy importers; the terms-of-trade swing is the mirror image for exporters
- Elevated global long rates raise the cost of holding and of rebuilding reserves

Questions for discussion

- When is "looking through" the right call, and what would tell you it is not?
- Are the usual indicators of second-round effects fast enough, given a two-year pass-through?
- How should reserve adequacy be assessed when the shock is persistent rather than temporary?



Thank you

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