KFW RESEARCH

Economics in Brief

One Pager

No. 89, 20th October 2015

Inflation quiet thanks to oil?

Author: Clemens Domnick, phone +49 (0)69 7431-1746, research@kfw.de

The euro area's inflation rate fell into negative territory between December 2014 and March 2015 and dipped below zero again in September. The sharp fall in oil prices is the main factor behind the dip into the red. Between June 2014 and January 2015, crude oil prices fell by nearly 60 % (from USD 114 to USD 48 per barrel). Having rallied slightly in the interim, it now stands at around USD 47 per barrel. So do we really have a deflation problem? How far will inflation rise once the slumping oil price drops out of the equation?

Direct effect is quickly apparent

The price of oil has a very direct impact on the prices of most energy products in the basket of goods used to calculate consumer price inflation (Figure 1). Moreover, energy prices account for around 11 % of the total index. As a result, in January 2012 energy prices made a positive contribution to consumer price inflation of around one percent. Since January 2015, though, the energy price component has reduced inflation by an average of 0.7 percentage points (Figure 2).

Indirect effects tend to be weak

But oil prices also influence producer prices and affect consumers in a roundabout way. For industry, lower energy costs mean lower input prices and hence lower costs. For example, pharmaceutical companies can produce drugs more cheaply and airlines can offer more affordable tickets. This means that changes in energy prices can also affect core inflation – a measure of inflation that excludes volatile components such as energy and food. It is difficult to estimate these indirect effects accurately but their influence is generally considered to be fairly limited. A simple regression analysis confirms that the quarterly rate of change in the oil price has only a small impact on the various core components of the inflation rate.

Looking ahead

If the oil price rises to USD 65 from October – at an exchange rate of USD 1.10 to the euro – and stays at that level for one year, the inflation contribution of the energy price component will turn positive again from December (Figure 2). From this scenario it is clear that inflation will rise due to base effects alone if oil prices stabilise at a higher level.

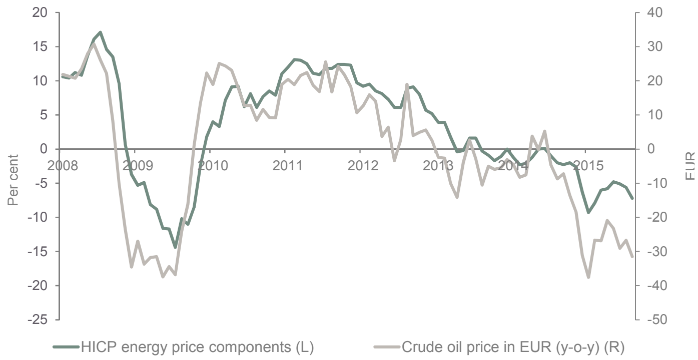
Core inflation is still too low

But that doesn't mean that inflation is about to go through the roof. Despite the positive contribution, the estimated inflation trend falls far short of the ECB's target. If oil prices settle at a lower level – for example, USD 55 – the energy contribution will remain negative for much of next year. The bottom line is: core inflation is too low by almost one percent, and very stable. The ECB will no doubt appreciate that inflation is being distorted by oil prices. It will be more concerned, and rightly so, about the danger of low core inflation leading to permanently low inflation expectations.

Conclusion

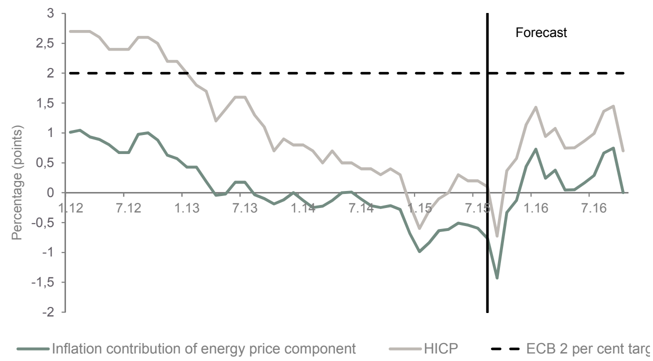
At the moment, euro area inflation is considerably distorted by the ups and downs of the oil price. Headline inflation is currently around one percentage point below core inflation but this effect should disappear after 12 months if oil prices remain stable going forward. Even so, the risk of deflation hasn't gone away: even if oil prices rise, there will be no significant jump in consumer prices. The ECB will therefore stick to its current monetary policy to achieve the desired inflation targets. ■

Figure 1: Oil price and HICP energy



Source: Thomson Reuters, own calculations.

Figure 2: HICP, energy component and forecast



Source: Thomson Reuters, ECB, own calculations.