GLOBAL ECONOMICS UPDATE

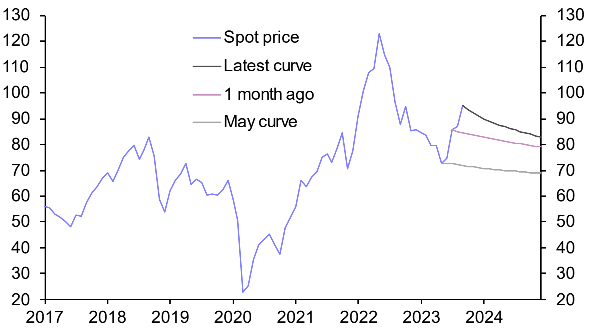
Higher oil prices not a game-changer for inflation

- **We are not convinced that the increase in oil prices has set the stage for a sustained rebound in inflation. Accordingly, there is little chance that developed market central banks will resume or extend tightening cycles in response. That said, if oil prices rose a lot higher and stayed there, policymakers would not be able to dismiss the risk of 'second-round effects' on inflation as easily as they did in recent decades.**

- Crude oil prices have marched higher across the curve on the back of Russian and Saudi supply cuts, with the spot Brent price rising from $70-75pb in May/June to $95pb currently. (See Chart 1.) We were already expecting the price to rise to $85pb by the end of the year as the market fell into a deficit. But now that the outlook for supply looks more constrained, we have raised our end-2024 forecast from $75pb to $85pb.

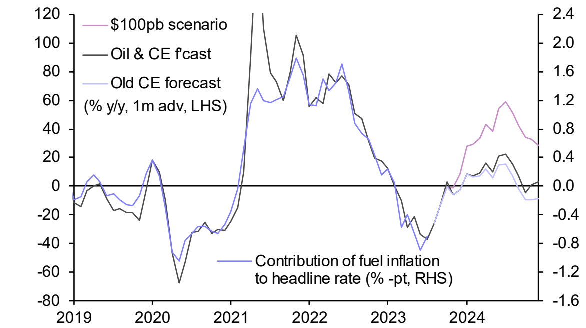
- **Higher fuel inflation was set to exert upward pressure on headline inflation rates in the coming year, and our higher oil price forecast doesn't alter the outlook much.** We were forecasting the percentage-point contribution of fuel inflation to the average headline rate in major advanced economies to rise by about 1%-pt from the middle of this year to mid-2024. Our new oil price forecast suggests that this effect could be 0.2%-pt higher at its peak, so not a game-changer. We would have to see oil prices rise to $100pb+ and stay there for there to be a more significant effect on inflation via higher retail fuel prices. (See Chart 2.)

Chart 1: Brent Oil Price ($ per barrel)



Sources: Refinitiv, Capital Economics

Chart 2: Oil Price & Fuel CPI Contribution in Major DMs



Sources: Refinitiv, Capital Economics

- **From a policy perspective, the bigger question is whether higher oil prices lead to higher core inflation.** According to the traditional central bank playbook, policymakers can afford to 'look through' commodity price swings because they are deemed to ordinarily have little effect on core price pressures and thus pose little danger to medium-term price stability. Indeed, we found that – before the pandemic – large oil price shocks had only minimal effects on core inflation and short-lived effects on headline rates in major DMs.

- **Admittedly, the risk of 'second-round effects' on core inflation may be higher in current circumstances.** As we pointed out in our report on 'greedflation', firms have been enjoying extensive pricing power, which has allowed them to pass on higher costs to consumers to defend margins to an unusual degree. What's to stop them passing on higher fuel costs too? Moreover, as we argued here, fuel prices are a key determinant of households' inflation expectations, which in turn can influence actual inflation when labour markets are tight, as they are today. **If the conditions are in place for higher oil prices to feed through to core inflation, this arguably raises the chances of a sustained rebound towards a 'twin peak' in inflation.**

- **But we are not too concerned about the knock-on effects of oil prices on core inflation for now.** For one thing, while firms' pricing power has been strong lately, narrowing margins and survey anecdotes suggest that it is now waning in North America. And with the euro-zone and UK economies seemingly slipping into recession, European firms are soon likely to find it harder to pass on higher fuel costs to consumers.

Simon MacAdam, Senior Global Economist, simon.macadam@capitaleconomics.com
Lily Millard, Assistant Economist, lily.millard@capitaleconomics.com

- And while fuel prices are an important driver of households' inflation expectations, so too are grocery prices and the signs are that food inflation will continue to moderate in the months ahead. So, it is not a given that higher fuel prices will lead to higher inflation expectations. **Even if higher fuel prices did cause expectations to rise, labour markets are cooling.** Consequently, if we look through the high-profile union strikes that make it into the news headlines, the underlying picture is that workers' ability to act upon higher inflation expectations to push for higher pay is weakening, especially in the US.

- **The upshot is that conditions are evolving such that the risks of 'second-round effects' from higher oil prices are diminishing.** It is true that higher oil prices are likely to have some *direct* effect on core inflation through higher prices of transport services, such as airfares. But given the small weight of public transport in CPI baskets, it is not going to move the needle on core inflation. Indeed, compared to the influence of fuel inflation on headline rates, the contribution of public transport inflation barely registers. (See Chart 3.) In any case, mild recessions in advanced economies and improved global supply chain conditions should outweigh any direct feedthrough from higher oil prices on core inflation in the year ahead. (See Chart 4.)

Chart 3: Contributions to DM Avg. Headline Rate (%-pts)

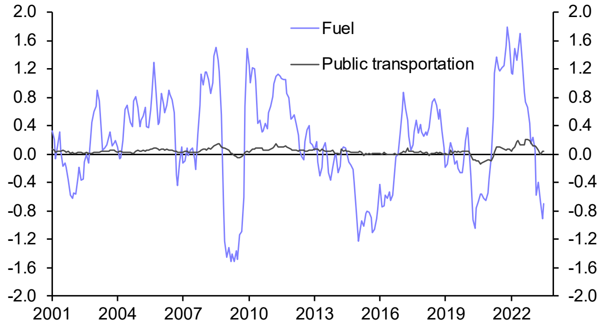


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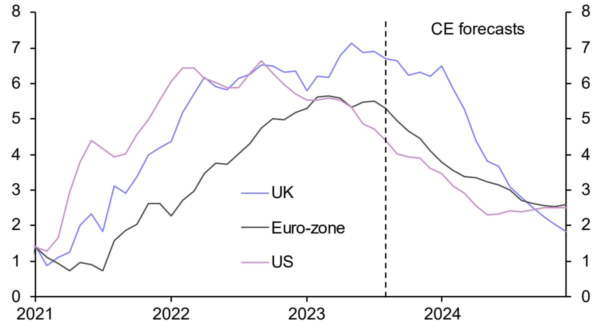
Chart 4: Core CPI Inflation (%)



Sources: Refinitiv, Capital Economics

- **While they are showing signs of diminishing, the risks of 'second-round effects' from higher oil prices are still higher now than they have been for decades. And given that inflation remains above target, the recent rise in oil prices creates a near-term headache for central banks, which they may well convey by toeing a hawkish line. But as things stand, we do not believe that the recent increase in oil prices will cause central banks in advanced economies to respond with interest rate hikes. For oil prices to have a bearing on the outlook for monetary policy, central banks would probably need to see prices rise higher and for a sustained period against a backdrop of resilient activity and rising inflation expectations.**

TORONTO NEW YORK LONDON SINGAPORE

Email **sales@capitaleconomics.com** Visit **www.capitaleconomics.com**