Financial markets have been very volatile in recent months, with many stock exchanges making spectacular recoveries after slipping into correction territory in mid-October. An even greater change beyond these significant fluctuations is the nosedive that oil and gasoline prices have taken since mid-2014. While the magnitude of the correction may look exaggerated, it now seems clear that oil and gas prices will continue to be significantly lower than previously anticipated.

The astonishing decline in gas prices, with the average U.S. price-per-gallon going from US$3.63 in mid-2014 to less than US$2.80, is applying downward pressure on inflation. Since gas represents a little more than 5% of the U.S. household consumption basket, prices at the pump plummeting this much could theoretically push inflation down by a little more than 1%. In reality, the effect could be even larger, as prices for other goods, such as air transportation and certain types of heating, should also fall. Up to now, however, the decrease in U.S. inflation seems less pronounced than could have been theorized.

One thing is certain, the short-term outlook on inflation in the United States is much weaker given sinking gas prices. Is it still appropriate in this context to expect an increase in key U.S. rates to begin in mid-2015? If the only effect of plunging gas prices was weaker inflation, the answer could be no. However, the plummet in gas prices is also a major stimulus to the U.S. economy. The nearly US$0.90 per gallon decrease seen since mid-2014 represents potential annual savings of around $US120B, or 0.7% of GDP, for all gas consumers in the United States (households, companies and public administrations).

Central banks, aware that it takes several months to see the effects of their actions on the economy and inflation, usually disregard temporary movements in inflation caused by external factors. The annual inflation rate may be weak in mid-2015, but the temporary effects of slumping gas prices will be poised to dissipate. Federal Reserve leaders will therefore base their decisions on the job market’s performance and real internal inflation pressure.

Implications: Despite a weaker short-term inflation outlook, we still expect U.S. key rates to start increasing around mid-2015, as everything points to the economy and the job market to continue advancing at a good pace.

Mathieu D’Anjou
Senior Economist