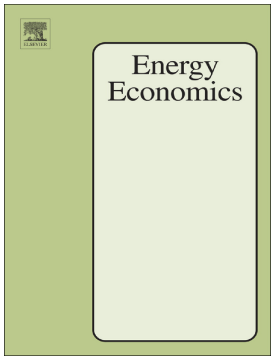

Oil price dynamics and market-based inflation expectations

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PII: S0140-9883(18)30383-9
DOI: doi:10.1016/j.eneco.2018.09.011
Reference: ENEECO 4158

To appear in: *Energy Economics*

Received date: 5 October 2017
Revised date: 12 September 2018
Accepted date: 12 September 2018

Please cite this article as: Shawkat Hammoudeh, Juan C. Reboredo , Oil price dynamics and market-based inflation expectations. Eneeco (2018), doi:10.1016/j.eneco.2018.09.011

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Revised version - September 2018

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Abstract

We examine the link between oil prices and market-based inflation expectations in the United States. Using a Gaussian affine term structure model, we decompose the breakeven inflation into three components: the market-based inflation expectations, the inflation risk premium and the liquidity risk premium. We show that oil prices have a nonlinear impact on the 5- and 10-year market-based inflation expectation components. Specifically, we find that the impact of oil price changes on inflation expectations is more intense when oil prices are above a threshold of 67 USD per barrel and is more pervasive for the intermediate term than for the longer term. Furthermore, we show that oil prices have a nonlinear impact on the inflation risk premium. These results have implications for the management of inflation expectations.

Keywords: Inflation expectations; Inflation risk premium; Oil prices; Threshold.

J.E.L. Classification: C22; D84; E31; Q43.

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