

Accepted Manuscript

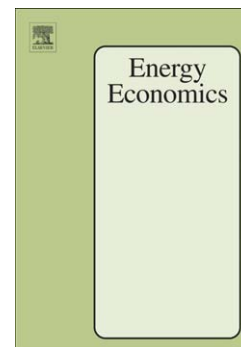
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PII: S0140-9883(16)30048-2
DOI: doi: [10.1016/j.eneco.2016.03.010](https://doi.org/10.1016/j.eneco.2016.03.010)
Reference: ENEECO 3295

To appear in: *Energy Economics*

Received date: 16 June 2015
Revised date: 23 February 2016
Accepted date: 10 March 2016



Please cite this article as: Castro, César, Jerez, Miguel, Barge-Gil, Andrés, The deflationary effect of oil prices in the euro area, *Energy Economics* (2016), doi: [10.1016/j.eneco.2016.03.010](https://doi.org/10.1016/j.eneco.2016.03.010)

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The deflationary effect of oil prices in the euro area

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February 23, 2016

Abstract

The inflationary effect of oil price has been widely examined by academic literature. Nowadays, the main concern in the euro area (E.A.) is its deflationary effect. In this paper we propose a method to evaluate the effect of oil price changes on inflation as well as an indicator of inflation adjusted for the short-term effect of oil prices, which is aimed to assess the risk of deflation in real time. We illustrate the practical applications of these tools by predicting the evolution of inflation in the E.A., conditional to different scenarios of oil price deflation. Our main finding is that no deflationary scenario for oil prices results in a negative inflation rate forecast for December 2016, despite oil price variation accounting for 25% of the variance of changes in inflation.

Keywords. Inflation, Deflation, Oil price, Euro area, Forecasts.

1 Introduction

The relevance of oil prices as a source of variations in prices is established since the 1970s. However, in the last two decades several works have documented that this relevance has decreased. Hooker [2002] finds no significant impact of oil prices changes on U.S. inflation, excluding energy products. DeGregorio et al. [2007] document an important reduction in the contribution of oil prices changes on consumer prices, providing evidence for a sample of 34 countries. Blanchard and Galí [2010] find that the inflationary impact of crude costs decreased since mid 1980s. Kilian [2008a,b] states that the effect of exogenous oil prices shocks

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