

The July surge in consumer prices marks the end of the recent increase in inflation. A simple statistical relationship between the price of oil and the Consumer Price Index (CPI) during the last 15 years points to a decline in inflation to about 2.5% by this time next year.

**The July surge in consumer prices marks the end of the recent increase in inflation. Today's 5.5% inflation rate could be as low as 2.5% by next summer.**

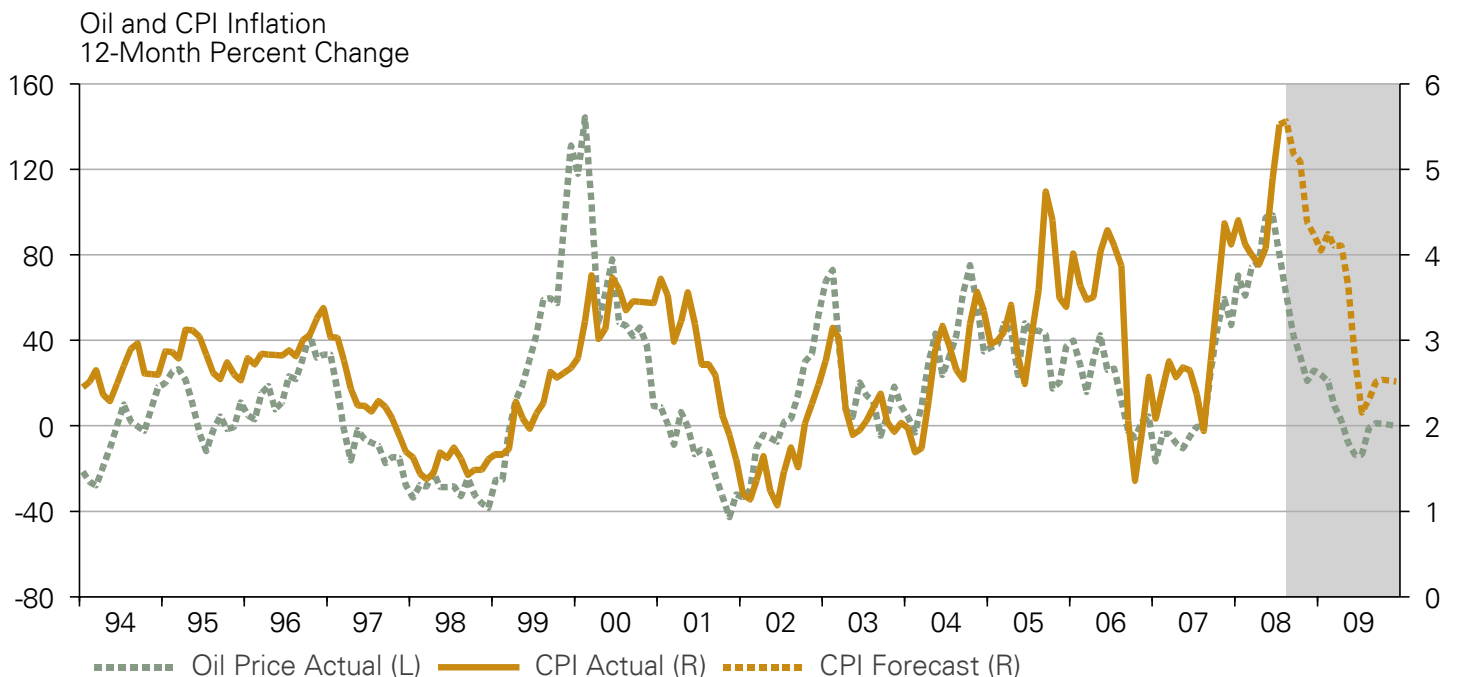
The inflation picture is widely viewed as cloudy. On the one hand, the weak dollar, rising prices for oil and other commodities, and rising nonpetroleum import prices appear to be pushing inflation higher. On the other hand, productivity growth remains sound, unit labor costs are under control, and domestic demand is weakening. Money supply growth appears consistent with higher-than-desired but lower-than-prevailing inflation. But sometimes things are simpler than they seem.

Forecasting inflation using this relationship requires (1) assuming that it will continue to hold and (2) making some assumption about the future price of oil. If the price of oil follows the current path of futures prices (which is approximately flat at today's level), the year-over-year rate of change in oil will fall to zero in the coming year. Based on the historical relationship, that implies a year-over-year rate of change in the CPI of about 2.5% a year from now.

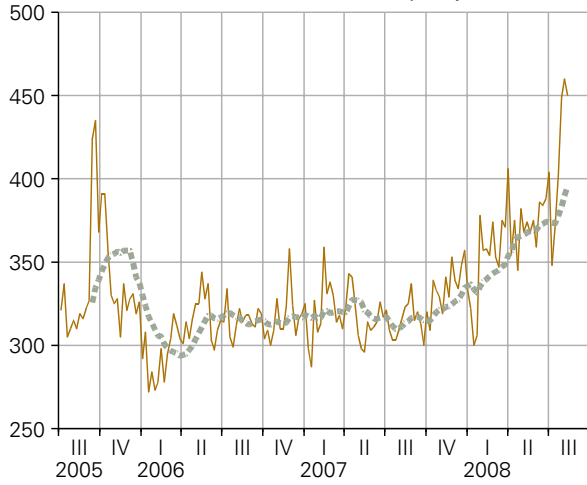
As the chart below shows, the year-over-year percent change in the monthly CPI has had a relatively close correlation with the year-over-year percent change in the price of oil for the last fifteen years. The price of oil was a better predictor of the level of inflation at some times than at others, but it almost always pointed in the right direction.

The outlook for 2.5% CPI inflation a year from now assumes a flat trajectory for oil prices in the year ahead, which might or might not unfold. But it also says that a resurgence in the price of oil is necessary for inflation to move higher.

Jim Coons



Initial Claims for Unemployment Insurance  
Thousands Per Week, Seasonally Adjusted



U. S. Dollar Exchange Rate  
FRB Major Currency Index, 1973 = 100



Price of Oil  
West Texas Int, \$/bbl



Price of Gold  
London PM Fixing, \$/oz



S&P 500 Stock Prices  
Daily Close, Index 1941-43 = 10



Mortgage Loan Originations  
MBA Purchase Index 3/16/90=100 SA

