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Drivers of Low Inflation in Malta after the Crisis

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Abstract

Despite robust growth, inflation in Malta has been subdued after the crisis and lower than what a Phillips curve would imply. This study examines the determinants of low inflation by comparing inflation forecasts conditioning on three groups of variables – real activity, external and financial – to see which one of these categories best explains post-crisis inflation. The analysis is conducted within a Bayesian VAR (BVAR) framework over two different disinflation periods, the first one starting in mid-2008 and the other one in 2012. For Malta, forecasts conditional on the path of the external variables are the closest to the actual path of inflation in both periods. On the contrary, in the euro area, the first episode was driven by external factors but domestic factors played a more important role in the second one. This point to the significant cross-country heterogeneity among euro area countries even in the face of apparently similar patterns in headline inflation.

Keywords: Inflation, Conditional forecasts, Bayesian Vector Autoregression, Cross-country comparison, Malta.

JEL classification: E31, E32, E37

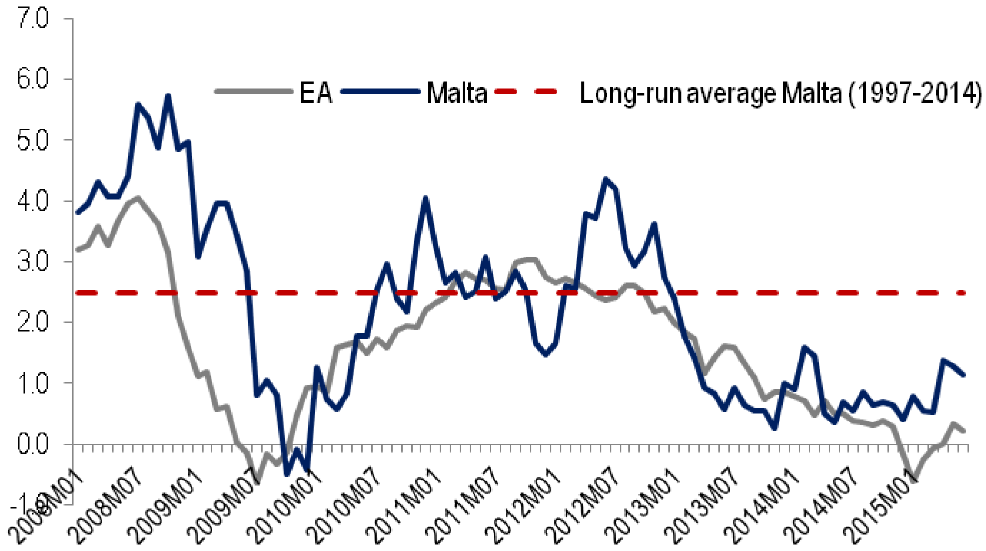
Introduction

Inflationary pressures in Malta, the smallest and one of the most open economies in the euro area, have been weak after the crisis despite above average economic growth. Inflation followed a similar pattern as in other euro area countries, with two disinflation periods; one starting around mid-2008 and the second one in 2012 (see Figure 1). While the first period was driven mainly by developments in the energy and food components, the second period was much more prolonged and more broad-based, driven by the contribution of energy from the reduction in utility tariffs and services inflation. Since 2013, inflation has also been systematically over-predicted and has been lower than what a Phillips curve would imply, especially given the strong GDP growth, the drop in unemployment to historical lows and the closure of the output gap.

Against this background, this study asks the following question: given the typical co-movements between macroeconomic variables, which group of variables does the best job explaining inflation dynamics after the crisis? This question is answered using forecasts of inflation conditional on three groups of variables – real activity, external and financial variables – over the two different disinflation periods computed with a Bayesian VAR (BVAR) framework.

For Malta, the forecasts conditional on the path of the external variables are the closest to the actual path of inflation in both periods. On the contrary, in the euro area, while external variables are best in explaining the disinflation period starting in 2008, the forecasts conditional on domestic real activity are the closest to the actual path of inflation for the second period. This pattern is shared by the largest members of the monetary union but not the smallest ones. This point to significant cross-country heterogeneity among euro area countries even in the face of apparently similar patterns in headline inflation.

The rest of the paper is organized as follows. Section 2 provides a brief literature review. Section 3 describes the model and section 4reports the main findings for Malta. Section 5 tests the sensitivity of the results and section 6 applies the same framework on a number of euro area economies. Section 7 concludes.



Source: own calculations using Eurostat data

Figure 1 - HICP inflation in Malta and the euro area: 2008-2015 (annual growth rates)

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Conclusion

This paper investigates the drivers of low inflation in Malta after the crisis using conditional forecasts within a Bayesian VAR framework. The reduced form nature of the exercise, however, captures correlations and not causal relationships. The latter requires a more structural approach, which is beyond the scope of this paper.

The two phases of low inflation since the crisis in Malta were both driven mainly by external factors. This is not surprising given the Malta is one of the most open economies in the EU with a high degree of import content. These results are also consistent with the view of a flattening of the Phillips curve in Malta, which explains why the robust GDP growth and the drop in unemployment to historical lows did not result in inflationary pressures. The inclusion of wages in the real activity indicators improves the fit of the model, suggesting that the structural changes in the domestic labor market could have potentially played an important role in keeping price pressures contained.

Cross-country comparisons point to a considerable degree of heterogeneity among the largest and smallest members of the monetary union, especially in the second phase of the crisis. For the euro area as a whole, the first disinflation period is best explained by the external variables but the second period was driven to a larger extent by domestic factors. This pattern is shared among the biggest economies but not by the smallest ones, for which external factors remain the most important category.

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