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Inflation Persistence in Europe: The Effects of The Covid-19 Pandemic and of The Russia-Ukraine War

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INFLATION PERSISTENCE IN EUROPE: 
THE EFFECTS OF THE COVID-19 PANDEMIC 
AND OF THE RUSSIA-UKRAINE WAR

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Abstract
This note analyses the possible effects of the Covid-19 pandemic and of the Russia-Ukraine war on the degree of inflation persistence in both the euro zone and the European Union as a whole (EU27). For this purpose a fractional integration model is estimated, first using the full sample and then recursively. Although the recursive analysis provides clear evidence of a significant increase in inflation persistence (especially in the case of the EU27, for which in addition to jumps an upward trend is clearly identifiable), the full-sample results imply long-lasting but only temporary effects of the two shocks being examined. These findings suggest that the required policy response to both shocks should also have a temporary nature.

Keywords: Inflation persistence; fractional integration; recursive estimation; Covid-19 pandemic; Russia-Ukraine war

JEL Classification: C22; E31

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1. **Introduction**

Since the beginning of 2020 two exogenous shocks have significantly affected world inflation, namely the Covid-19 pandemic and the Russia-Ukraine war. Pandemics usually give rise to both inflationary and deflationary dynamics; specifically, the disruption in the supply and production chain causes supply-side inflation; in addition there are deflationary forces reflecting higher idiosyncratic risk; these can be moderated by redistribution policies which, however, can lead to excessive inflation in the longer term (Brunnermeier et al., 2020). The Covid-19 pandemic also led to a sudden increase in inflation uncertainty (Armantier et al., 2021), and to changes in consumer expenditure patterns that introduced a bias in the measurement of inflation, with the official Consumer Price Index (CPI) inflation being lower than actual inflation (Cavallo, 2020). In particular, the under-weighting of increasing food prices and the over-weighting of declining transport prices appear to have been the main reasons for underestimating inflation (Reinsdorf, 2020).

The Russia-Ukraine war has also affected prices. Any armed conflict has a significant impact on macroeconomic variables but measuring it might not be straightforward. Ruiz Estada (2022) uses a war economic destruction level simulator (WEDL-Simulator) and finds large spillover effects of the Russia-Ukraine war on both inflation and unemployment worldwide. Bodnar et al. (2022) examine euro zone food inflation and report that global energy and food commodity prices had been driving it upwards since the second half of 2021 and that the war has increased it further by hindering the import of energy and food commodities. Finally, Prohorovs (2022) argues that the global trade restrictions that the war has brought about can have long-lived effects on prices.
The present study focuses on a specific aspect of inflation for which the possible effects of both the Covid-19 pandemic and the Russia-Ukraine war have not been previously considered, namely its degree of persistence. More precisely, fractional integration methods are applied to measure inflation persistence in both the euro zone and the European Union as a whole (EU27) using monthly data from September 1997 to August 2022. The model is estimated first for the whole sample, and then recursively from December 2019 to examine the evolution over time of inflation persistence and thus the possible impact of the recent pandemic and conflict respectively. The chosen framework is more general than the standard one based on the dichotomy between I(0) stationarity and the I(1) non-stationarity since it allows for fractional as well as integer degrees of differentiation; as a result, it encompasses a much wider range of stochastic processes, it sheds light on whether the effects of shocks are transitory or permanent, on whether or not mean reversion occurs, on the speed of the dynamic adjustment process etc., thereby providing useful information to policy makers on the type of policy actions required.

The rest of the paper is structured as follows: Section 2 describes the data, presents the model and the empirical results; Section 3 offers some concluding remarks.

2. **Empirical Analysis**

For the empirical analysis we use monthly data on the harmonized index of consumer prices (HICP) produced by Eurostat (the statistical office of the European Union) and available on the Bloomberg platform; more precisely, we examine the properties of two series, namely MUICP, which is an aggregate index for the countries in the euro zone, and EICP, which is the corresponding index for the EU27, from September 1997 to
August 2022. The data are not seasonally adjusted. Inflation is calculated as the monthly rate of change (M) of consumer prices in year $t$ and month $m$:

$$M_{m,m-1}^t = \left( \frac{I_m^t}{I_{m-1}^t} - 1 \right) \times 100$$

To allow for the possible presence of long memory and/or seasonality as well as of deterministic components in the series we consider the following model:

$$x_t = \alpha + \beta t + z_t; \quad (1 - L)^d z_t = u_t, \quad u_t = \rho u_{t-12} + \varepsilon_t, \quad (1)$$

where $x_t$ stands for the series of interest; $\alpha$ and $\beta$ are unknown parameters, specifically the constant and the coefficient on a linear time trend; $L$ is the lag operator, $d$ is a real value, and thus $z_t$ is integrated of order $d$; $u_t$ is a seasonal AR(1) process which is I(0), and $\rho$ is the seasonal AR coefficient. The estimation is carried out using a Whittle function in the frequency domain. Note that if $d = 0$ the process exhibits short memory, while $d > 0$ implies long memory; if $d$ belongs to the range $(0, 0.5)$ the series is covariance stationary and mean-reverting, while if $d$ is in the interval $[0.5, 1)$ the process is nonstationary though still mean-reverting. The series exhibits a unit root when $d = 1$; in this case (and also if $d > 1$) shocks have permanent effects.

Table 1 reports the estimated coefficients for each of the two series from a model with an intercept only as the time trend was not found to be significant. In both cases, the estimates of $d$ are in the range $(0, 0.5)$, which implies the presence of long memory and long-lived, though transitory, effects of shocks; specifically, the estimated value of $d$ is 0.24 for the euro zone and 0.31 for the EU27, the seasonal component being significant in both cases.
Next we estimate the parameter d recursively from December 2019 by adding one observation at a time; the aim is to investigate the evolution over time of persistence and if/how it has been affected by the Covid-19 pandemic and the Russia-Ukraine war. Figure 1 displays both the recursive estimates and the 95% confidence intervals. In the case of the euro zone upward jumps in inflation persistence appear to have occurred in February and May 2020, namely in the early stages of the pandemic; persistence then only increases slightly and remains relatively stable till November 2021, before another upward jump in March 2022 (which is around the time of the Russian invasion) and a subsequent slight decrease. As for the behaviour of inflation in the EU27, it is noticeable that its persistence increases throughout the sample, first jumping up in June 2020 and then again in March 2022, at the start of the conflict.

3. Conclusions

Exogenous shocks such as pandemics and wars can have a significant impact on economic variables such as inflation, as shown by various previous studies (e.g., Brunnermeier et al., 2020: Ruiz Estada, 2022). This note focuses on one particular issue, namely the possible effects of the Covid-19 pandemic and of the Russia-Ukraine war on the degree of inflation persistence in both the euro zone and the EU27. The adopted empirical framework, which is based on the concept of fractional integration, is very general and it encompasses a variety of stochastic processes; moreover, it is informative about the (transitory or permanent) effects of shocks. The model is estimated in the first instance using the full sample and then recursively to examine the impact of the pandemic and of the ongoing conflict in Ukraine.

Interestingly, although the recursive analysis provides clear evidence of a significant increase in inflation persistence (especially in the case of the EU27 for which
in addition to jumps an upward trend is clearly identifiable), the full-sample results imply long-lasting but only temporary effects of the two shocks being considered. These findings suggest that the policy response to both shocks should also have a temporary nature, and in fact this appears to have been the approach followed by national governments, the measures introduced to deal with the Covid-19 pandemic having already been phased out in most cases, and the response to the energy crisis caused by the current conflict having a clearly defined, finite time horizon.
References


Bloomberg L.P. https://www.bloomberg.com/company/


Table 1: Estimated coefficients in the model given by Eq. (1)

<table>
<thead>
<tr>
<th>Series</th>
<th>d</th>
<th>Intercept (t-value)</th>
<th>Seasonality (p)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euro zone</td>
<td>0.24</td>
<td>0.1956 (2.78)</td>
<td>0.806</td>
</tr>
<tr>
<td>EU27 (all 27 EU members)</td>
<td>0.31</td>
<td>0.1839 (4.75)</td>
<td>0.790</td>
</tr>
</tbody>
</table>

Note: the numbers in brackets in the column for d correspond to the 95% confidence intervals.

Figure 1: Recursive estimates of d as a measure of inflation persistence

Note: The first estimate is d based on a sample ending in December 2019, then one observation at a time is added recursively to obtain the following estimates. Thus, observation 1 corresponds to the sample ending in January 2020, observation 2 to the one ending in February 2020, etc. The red line corresponds to the estimated values of d whilst the black ones show the 95% confidence intervals.