

R Notebook

Criteria for evaluation : forecasting future inflation

The ability of the core inflation indicator to predict future headline inflation can be quantified by the following regression equation.

Here, x represents the headline inflation rate and x^{core} represents some core inflation indicator, both year-on-year data. Parameter h is 12 (month) ahead in this case. For sufficiently large H , the core deviation, $(x_t^{\text{core}} - x_t)$, should be inversely related to subsequent changes in inflation, $x_{t+h} - x_t$. Moreover, in order for the candidate to satisfy equation (1), the coefficients in the regression, should satisfy $\alpha = 0$ and $\beta_H = -1$.

$$x_{t+h} - x_t = \alpha + \beta (x_t^{\text{core}} - x_t) + \varepsilon_t \quad (1)$$