

External Shocks and Inflation

Nektarios A. Michail* and Christos S. Savva

Abstract

We investigate how the price of crude oil, the cost of food, and the Euribor rate affect inflation in Cyprus. To do so, we use a Vector Error Correction (VEC) methodology for the 2008–2021 period for both the headline and the main components of the Harmonized Index of Consumer Prices (HICP). As expected, the magnitude of the shocks' effects on inflation varies depending on the component. Energy inflation, expectedly, has the largest response to an oil price shock, given Cyprus' dependence on oil as an energy source. The estimates are consistent with the developments in energy inflation in the first half of 2022, but the other components do not react in accordance with the data, pointing to the possible existence of non-linearities. Finally, positive shocks to the Euribor cause all inflation categories to decline, albeit to a small extent.

Keywords: Vector Error Correction, Cyprus, Inflation, HICP, Brent oil, food prices.

* Corresponding Author, Address: Energy, Environment and Water Research Center, The Cyprus Institute, P.O. Box 27456, 1645 Nicosia, Cyprus, Tel. +357 22208683, E-mail: e.giannakis@cyi.ac.cy.