

Forecasting Deflation Probability in the EA: A Combinatoric Approach

Luca Brugnolini

Central Bank of Malta

Abstract

I develop a two-step subset selection procedure to extract the best-performing predictors from a large dataset and combine them to identify a set of best-performing models. I apply the methodology to build an index to forecast the probability of having the euro area year-on-year inflation below the 2% level in a medium-term horizon---i.e., the Deflationary Pressure Index (DPI). I compare the index with the probabilities reported in the European Central Bank Survey of Professional Forecasters (ECB SPF) and show that, although the indices are comoving, the DPI is more operationally convenient and timely in catching the inflation turning points.

JEL Classification: C25, C63, E3, E58

Key Words: inflation, prediction, index, euro area, ECB