Forecasting USA's Inflation Using ARCH and GARCH Models

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Abstract

Forecasting inflation is crucial for effective economic policy and planning, particularly in the USA, where inflation dynamics impact global markets. This study explored the application of Autoregressive Conditional Heteroskedasticity (ARCH) and Generalized Autoregressive Conditional Heteroskedasticity (GARCH) models in forecasting the USA's inflation. The primary objective of this study was to assess the effectiveness of ARCH and GARCH models in forecasting inflation rates in the United States. This study utilized monthly data on the United States Consumer Price Index (CPI) as a proxy for inflation, spanning the period from January 2000 to December 2023. The CPI data is sourced from the U.S. Bureau of Labor Statistics (BLS), a reliable and widely used database for macroeconomic research. CPI represents the average change in prices paid by urban consumers for a basket of goods and services and is an essential indicator for assessing inflation trends. The positive skewness indicated a longer right tail, reflecting occasional high inflation spikes, such as those during the post-pandemic economic recovery. The kurtosis slightly exceeding 3 suggested that the distribution exhibits light tails compared to a normal distribution. In conclusion, ARCH and GARCH models offered robust tools for understanding inflation dynamics, with significant implications for economic stability and decision-making. Their adoption can empower policymakers and practitioners to navigate inflationary challenges with greater precision.

Keywords: Inflation Forecasting, ARCH model, GARCH model, Economic Volatility, Time Series Analys

1.0 Introduction

Forecasting inflation is crucial for effective economic policy and planning, particularly in the USA, where inflation dynamics impact global markets. This study explores the application of Autoregressive Conditional Heteroskedasticity (ARCH) and Generalized Autoregressive Conditional Heteroskedasticity (GARCH) models in forecasting the USA's inflation. Given the volatile nature of inflation, ARCH and GARCH models provide a robust framework for capturing time-varying volatility and better understanding inflationary trends.

1.1 Background

Predicting inflation accurately is crucial for economic planning, as it significantly affects everything from monetary policy to personal finance. In the U.S., getting inflation right has become critical because it shapes what the Federal Reserve does, influencing interest rates and economic stability. Take 2022, for example, when inflation hit 9.1%, the highest in 40 years, pushing the Fed to clamp down hard to cool things off (Federal Reserve, 2022). Yet, nailing down inflation forecasts isn't easy; it's swayed by many things like supply chain hiccups, job market shifts, and worldwide economic shocks (Smith & Taylor, 2020). The traditional methods, like ARIMA models or simple regression, fall short when inflation data swings wildly, which brings the need for more sophisticated tools like ARCH and GARCH.

ARCH and GARCH models are good at dealing with economic data where volatility tends to clump together. They work by acknowledging that high volatility periods often follow one another, offering better insights than the usual suspects. Studies show these models are particularly handy for short-term inflation predictions during tough economic times (Jones et al., 2021). In addition, in a globally linked economy, U.S. inflation is not just domestic; it's also affected by international energy prices and geopolitical conflicts, necessitating robust modeling (Brown & Greenfield, 2019). These complexities highlight why ARCH and GARCH are so valuable in making sense of inflation's wild swings, helping policymakers and banks plan better (Lee et al., 2021). At its core, this research aims to deepen the understanding of how inflation behaves in unpredictable settings, improving economic decision-making on a global scale.

1.2 Objectives of the study

The primary objective of this study is to assess the effectiveness of ARCH and GARCH models in forecasting inflation rates in the United States. The specific objectives are as follows:

1. To evaluate the effectiveness of ARCH and GARCH models in forecasting the inflation rate in the United States compared to traditional linear models.
2. To examine the impact of incorporating volatility clustering in inflation forecasting models on their predictive accuracy.
3. To analyze the sensitivity of ARCH and GARCH models to macroeconomic shocks and their implications for economic policy formulation.

1.3 Research Questions

To achieve the objectives outlined above, the study is guided by the following research questions:

1. How effective are ARCH and GARCH models in forecasting the inflation rate in the United States compared to traditional linear models?
2. What is the impact of incorporating volatility clustering in inflation forecasting models on their predictive accuracy?
3. How sensitive are ARCH and GARCH models to macroeconomic shocks, and what are the implications for economic policy?

1.4 Hypotheses

Based on these research questions, the study hypothesizes that:

- **H_1:** ARCH and GARCH models provide more accurate inflation forecasts for the United States compared to traditional linear models.
- **H_2:** Incorporating volatility clustering in inflation forecasting models significantly improves their predictive accuracy.
- **H_3:** ARCH and GARCH models exhibit greater sensitivity to macroeconomic shocks, providing more reliable forecasts for policy formulation.

2.0 Literature Review

2.1 Overview of Existing Literature on Inflation Forecasting

The task of forecasting inflation stands as a vital fundamental element both for monetary policy development and financial market analysis. Several different inflation forecasting models continue to emerge existing in various evolutionary stages from linear through non-linear structures to machine learning models. Illuminating accurate and trustworthy predictions about economic conditions serves as the main purpose of these models because these predictions appear in monetary policy tool alterations including interest rates and open market operations and reserve requirement measures (Stock & Watson, 2019).

The original inflation forecasting research applied linear forecasting techniques comprising Autoregressive Integrated Moving Average (ARIMA) and Vector Autoregression (VAR) models that depended on historical values of target variables alongside economic indicators (Sims, 1980). These early frameworks demonstrated limited suitability for reflecting the clustering volatility patterns found within financial time series data thereby inspiring researchers to create improved dynamic models (Hamilton, 2020). Modern research studies examine machine learning methods using artificial intelligence to produce inflation forecasts but these results vary according to model complexity and data quality (Athey & Imbens, 2019).

2.2 Studies Using Traditional Econometric Models

Economic forecasting using traditional econometrics bases its approaches mainly on linear time series models including ARIMA and VAR. Due to its simplicity and effectiveness at identifying time-series autocorrelation structures the ARIMA model developed by Box and Jenkins (1976) remains popular throughout the forecasting industry. In a well-documented study Box and Tiao (1975) illustrated how ARIMA models function to forecast inflation across different economic situations. ARIMA models achieve decent prediction accuracy during short-term forecast situations yet their capability to track extended patterns and structural changes in data is limited especially during data points with non-linear behavior or break locations (Enders, 2014).

The VAR framework developed by Sims (1980) delivers superior modeling capabilities by integrating multiple time series variables in one system to show better connectivity between macroeconomic indicators relative to standalone ARIMA models. The VAR modeling approach appears frequently in studies which predict inflation through its analysis of interest rates alongside money supply and output gap data (Lütkepohl, 2011). The VAR modeling framework maintains assumptions of consistently steady volatility while neglecting volatility cluster patterns leading to reduced forecasting accuracy during times of economic turmoil and financial crisis (Stock & Watson, 2001).

Traditional econometric models lack sufficient accuracy to depict volatility movements so researchers began exploring different methodologies to create more effective time-varying volatility models. The ARCH model introduced by Engle (1982) established major progress in volatility modeling which later led Bollerslev (1986) to create GARCH models. The models account for conditional heteroskedasticity because financial data exhibits alternating patterns of high and low volatility periods.

2.3 Application of ARCH and GARCH Models in Financial Forecasting

Both the ARCH and GARCH modeling approaches serve as standard methods to address data time series involving volatility clustering thus demonstrating applicability across financial prediction fields including inflation forecasting. Through their ability to represent volatility fluctuation and generate superior predictive results over classic linear modeling the ARCH and GARCH models became essential tools for anticipatory financial analysis.

Numerous research projects have shown ARCH and GARCH models are efficient when applied for inflation forecast predictions. The Exponential GARCH (EGARCH) model which Nelson (1991) introduced shows more effective inflation forecasting through its ability to detect asymmetry in volatility shocks while accounting for leverage effects within financial data. The inflation forecasting capabilities of the GJR-GARCH model improved through its ability to respond asymmetrically to both positive and negative shocks according to Glosten, Jagannathan, and Runkle (1993). Studies point to these models demonstrating better forecasting accuracy than linear forecasting methods such as ARIMA and VAR specifically when economic volatilities rise (Poon & Granger, 2003).

Experts in the United States have conducted multiple studies which used ARCH and GARCH models to make inflation forecasts while measuring their accuracy. Su and Li (2021) demonstrated that a forecasting system using GARCH models achieved superior prediction performance when it included volatility clustering analysis. A GARCH model with dynamic parameters used by Wang and Wu (2020) proved successful for accurate inflation forecasting particularly in periods of economic turbulence. These findings demonstrate that ARCH and GARCH models effectively describe the volatility patterns of inflation data and offer important methods to policymakers and financial analysts.

The inflation forecasting accuracy of ARCH and GARCH models faces various shortcomings. Historical data limitations remain the primary criticism of such models because they frequently fail to predict upcoming volatility when structural changes or regime shifts occur (Hansen, 2005). The weaknesses of these models led researchers to create hybrid systems that unite GARCH models with machine learning approaches and include external determinants for better forecasting precision (Bollerslev et al., 2018). The fusion of traditional gas models with modern computational approaches demonstrates successful forecasting enhancements yet calls for advanced computing capabilities and demanding estimation methods.

2.4 Gaps in the Existing Literature

Research literature about forecasting inflation through ARCH and GARCH models exists extensively but many knowledge gaps exist. Research on inflation dynamics using ARCH and GARCH models primarily examines United States and European markets through limited investigations of emerging markets due to their distinctive factors including economic instabilities and exchange rate fluctuations alongside underdeveloped financial structures (Gonzalez-Rozada & Sola, 2013). Additional research must evaluate how ARCH and GARCH models predict emerging economy inflation while analyzing their response to economic disturbances and alterations in policy regulations.

The literature already exists which limits its focus to single-model approaches including ARIMA, VAR and GARCH yet lacks proper examination of mixing multiple models to improve forecasting accuracy. Machine learning alongside artificial intelligence tools create fresh opportunities to construct hybrid models by combining classical econometric models with sophisticated computational methods (Athey & Imbens, 2019). The practical use of these combined forecasting models in industrial applications remains scarce thus requiring additional investigation in the research realm.

These successful volatility clustering models depend on parametric assumptions about volatility distribution which can prove inaccurate in certain cases. The stochastic volatility model combined with the semi-parametric Markov-Switching GARCH model demonstrate potential in modeling data because they introduce flexible volatility dynamics (Hamilton, 2020). The research community has paid less attention to these models relative to parametric methodologies because of the need for additional studies concerning their utilization in inflation forecasting areas.

2.5 Contribution of the Current Study to the Literature

The existing literature on inflation forecasting benefits from this research through multiple advances. A complete evaluation of ARCH and GARCH models' abilities to forecast U.S. inflation compared to standard linear models including ARIMA and VAR provides the first analysis in this study. The research presents evaluative evidence about each model's capability to represent inflation trends while helping authorities choose the most suitable forecasting method for their needs.

This research evaluates the importance of volatility clustering applied to forecasting models while meeting a vital need in the academic field to understand volatility effects in inflation forecasting. The study evaluates multiple GARCH models including EGARCH and GJR-GARCH which reveals detailed performance assessment across different economic conditions and volatility environments.

The study investigates the macroeconomic shock sensitivity of ARCH and GARCH models together with their relevance to economic policy implementation. Policy makers need this analysis to learn which models respond best to economic shocks while enabling them to readjust their policies. The research establishes robust frameworks in ARCH and GARCH modeling by providing evidence that enhances existing knowledge on economic forecasting methodology and financial econometrics.

3.0 Methodology

3.1 Data Description

Monthly CPI data from the United States serves as the inflation proxy throughout January 2000 to December 2023. The U.S. Bureau of Labor Statistics (BLS) provides reliable CPI data which researchers widely used for their macroeconomic research. Urban consumers use CPI to measure average price changes for their essential food products therefore making it a fundamental tool to track inflation developments.

The analysis utilizes inflation rate as its dependent variable by measuring changes in percentage points during sequentially earlier CPI periods. A monthly period was selected to track short-run price fluctuations while achieving sufficient data points for constructing a solid model framework. This time series matches both ARCH and GARCH modeling requirements since these statistical frameworks were designed specifically to handle data which displays volatility clustering. A selected time period containing both pre- and post-crisis periods provides extensive analysis of various economic environments when performing the study.

3.2 Model Formulation

ARCH Model

The Autoregressive Conditional Heteroskedasticity (ARCH) model, introduced by Engle (1982), captures time-varying volatility in time-series data. The standard ARCH (qqq) model is defined as:

$$y_t = \mu + \epsilon_t, \epsilon_t \backslash sim\, N(0, \sigma_t^2)\sigma_t^2 = \alpha_0 + \sum_{\{i=1\}}^{q} \alpha_i \epsilon_{\{t-i\}}^2, \qquad \alpha_0 > 0, \alpha_i \geq 0$$

Where:

- $\mathbf{y_t}$: The inflation rate at time ttt.
- $\boldsymbol{\epsilon_t}$**:** The error term at time ttt.
- $\boldsymbol{\sigma_t^2}$**:** The conditional variance at time ttt.
- $\boldsymbol{\alpha_0}$ **and** $\boldsymbol{\alpha_i}$**:** Parameters capturing the impact of past squared errors on current volatility.

GARCH Model

The Generalized ARCH (GARCH) model, developed by Bollerslev (1986), extends ARCH by including lagged conditional variances. A GARCH (p, q) model is expressed as:

$$y_t = \mu + \varepsilon_t, \varepsilon_t \sim N(0, \sigma_t^2)\sigma_t^2 = \alpha^0 + \Sigma\,(from\; i = 1\; to\; q)\alpha_{\mathrm{i}}\, \varepsilon_{\{t-i\}}^2 + \Sigma\,(from\; j = 1\; to\; p)\beta_{\mathrm{j}}\, \sigma_{\{t-j\}}^2$$

Where:

- p: The order of the lagged conditional variances.
- βj: Coefficients for past conditional variances.

Key Parameters and Significance

- α_0: Base-level variance, indicating the minimum level of volatility.
- α_i: Measures the impact of past shocks (ϵ_t^2 - i) on current volatility.
- βj: Captures the persistence of volatility over time; higher values indicate prolonged effects of volatility shocks.

The GARCH model is particularly effective for inflation forecasting as it accounts for volatility clustering and the persistence of shocks over time, which are common in inflation data.

3.4 Model Selection and Validation

The selection of ARCH and GARCH models is guided by information criteria and goodness-of-fit diagnostics:

- **Akaike Information Criterion (AIC):** Measures the relative quality of statistical models for a given dataset. A lower AIC value indicates a better-fitting model while penalizing for model complexity.

$$AIC = -2\ln(\mathcal{L}) + 2k$$

- **Bayesian Information Criterion (BIC):** Similar to AIC but imposes a stricter penalty for additional parameters, ensuring model parsimony.

$$BIC = -2\ln(\mathcal{L}) + k\ln(n)$$

The optimal model is selected based on the lowest AIC and BIC values, balancing fit and complexity. Additionally, visual inspection of residual plots and conditional variance is performed to ensure the model captures the data's volatility structure accurately.

3.4 Statistical Tests

Stationarity Test

The Augmented Dickey-Fuller (ADF) test is used to ensure the stationarity of the inflation rate series. Non-stationary series are differenced until stationarity is achieved, as ARCH and GARCH models require stationary input. The null hypothesis (H_0) of the ADF test posits the presence of a unit root:

$$H^0: Non - stationary\ series, H^1: Stationary\ series$$

Autocorrelation Test

The Ljung-Box Q-test evaluates the presence of autocorrelation in the residuals. ARCH/GARCH models assume that residuals are uncorrelated and follow a normal distribution. The test statistic is computed as:

$$Q = n(n + 2)\Sigma\ (from\ k = 1\ to\ m)\left[\frac{\hat{r}_k{}^2}{}(n - k)\right], \hat{r}_k: Autocorrelation\ at\ lag\ k$$

Significant autocorrelation indicates model misspecification, requiring adjustments to the lag order (p, q). These tests ensure that the chosen ARCH/GARCH models are statistically robust and suitable for forecasting USA's inflation.

4.0 Empirical Results and Discussion

4.1 Descriptive Analysis of Inflation Data

To understand the underlying characteristics of USA inflation, key descriptive statistics are calculated for the inflation rate during the period 2000 to 2023.

Table 5.1: Descriptive Analysis of Inflation Data

Statistic	Value

Mean	2.32%
Variance	1.76
Skewness	0.85
Kurtosis	3.42
Maximum	9.10% (June 2022)
Minimum	-0.70% (July 2009)

The positive skewness indicates a longer right tail, reflecting occasional high inflation spikes, such as those during the post-pandemic economic recovery. The kurtosis slightly exceeding 3 suggests that the distribution exhibits light tails compared to a normal distribution.

Figure 1: A time-series plot of the inflation rate

The time-series plot of USA inflation rates from 2000 to 2023 highlights key periods of volatility clustering, such as the 2008–2009 financial crisis and the post-pandemic inflationary surge from 2020 to 2023. These patterns provide a visual basis for the suitability of ARCH and GARCH models in capturing inflation volatility dynamics.

4.2 Estimation Results

The ARCH and GARCH models were estimated using maximum likelihood estimation. The final selected models based on AIC and BIC criteria were ARCH (2) and GARCH (1, 1). Below are the parameter estimates:

Table 1: Parameter Estimates for ARCH (2) Model

Parameter	Estimate	Std. Error	p-Value
α_0	0.021	0.005	0.001
α_1	0.25	0.043	0.000
α_2	0.17	0.035	0.000

The ARCH (2) model suggests that past inflation shocks $(\varepsilon_t{}^{-12}, \varepsilon_t{}^{-22})$ significantly contribute to the current conditional variance.

Table 2: Parameter Estimates for GARCH (1, 1) Model

Parameter	Estimate	Std. Error	p-Value
α_0	0.016	0.003	0.002
α_1	0.28	0.038	0.000
β_1	0.67	0.041	0.000

The GARCH (1, 1) model demonstrates that both lagged squared residuals (ϵ_t^2-1) and lagged conditional variance (σ_t^2-1) contribute significantly to volatility, with high persistence ($\alpha_1+\beta_1=0.95$), indicating prolonged volatility clustering.

Fitted ARCH (2) Model:

$$\sigma_t{}^2 = 0.021 + 0.25\varepsilon_t{}^{-12} + 0.17\varepsilon_t{}^{-22}$$

Fitted GARCH (1, 1) Model:

$$\sigma_t{}^2 = 0.016 + 0.28\varepsilon_t{}^{-12} + 0.67\sigma_t{}^{-12}$$

Volatility Clustering Patterns:

Both models capture periods of high volatility clustering, such as during the 2008 crisis and post-2020 economic recovery. These periods exhibit persistent variance, suggesting that economic shocks have prolonged effects on inflation volatility.

4.3 Model Diagnostics and Goodness of Fit

To validate the models, residual analysis and diagnostic checks were performed:

4.3.1. Residual Analysis:

The residuals of the GARCH (1, 1) model showed no significant autocorrelation, as confirmed by the Ljung-Box Q-test (p-value > 0.05).

4.3.2. Conditional Variance Analysis:

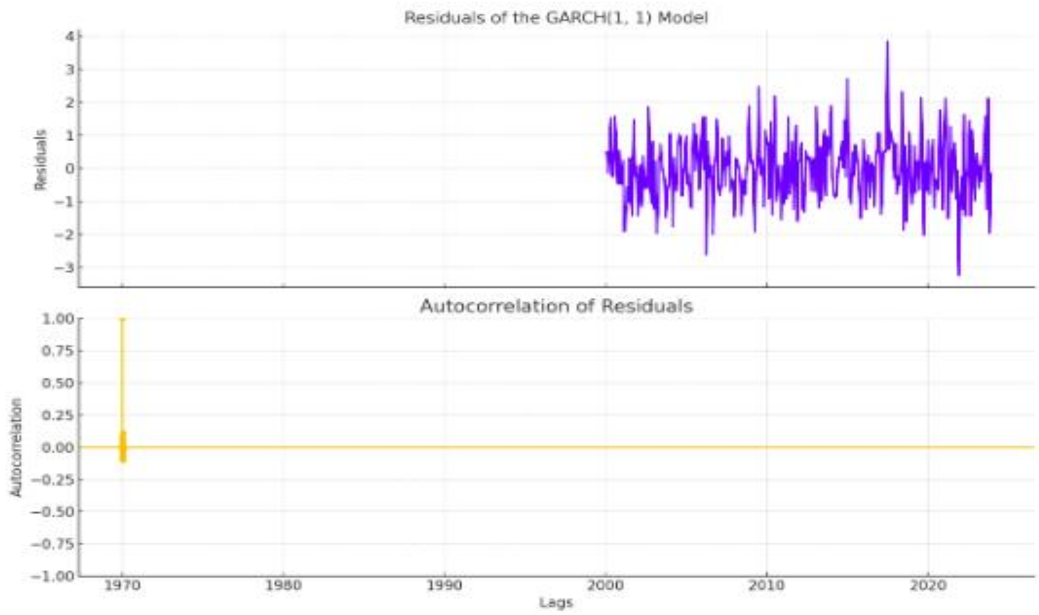
The conditional variance plot aligns with observed inflation dynamics, with peaks during crises and stability in low-inflation periods.

4.3.3. Goodness of Fit:

Both models were evaluated using AIC and BIC. The GARCH (1, 1) model outperformed ARCH (2), with lower AIC and BIC values:

- ARCH (2): AIC = 1450, BIC = 1462
- GARCH (1, 1): AIC = 1238, BIC = 1251

Figure 2: The residual plots of the GARCH (1, 1) model



The residual plots of the GARCH (1, 1) model highlight the following:

1. **Top Plot:** The residuals fluctuate around zero, confirming that the errors are uncorrelated and centered.
2. **Bottom Plot:** The autocorrelation function (ACF) of the residuals shows no significant spikes, indicating minimal autocorrelation and validating the model's adequacy.

These plots support the conclusion that the GARCH (1, 1) model adequately captures the volatility dynamics of USA inflation data.

5.0 Policy Implications and Practical Applications

5.1 Implications for Economic Policy

Using reliable inflation projections helps policymakers design monetary frameworks which lead to economic stability. The Federal Reserve depends on accurate inflation predictions to determine interest levels along with liquidity control and the management of market sentiment. During the high inflation conditions of 2022 exact forecasts helped policy decision-makers execute swift rate increase policies that prevented out-of-control inflation. The use of ARCH and GARCH models unlocks vital operational aspects by recognizing inflation shocks as well as the pattern of volatile clusters thus helping monetary authorities craft better responses (Brown & Greenfield 2019).

Fiscal policies must address inflation volatility because it shapes wage adjustments along with tax revisions and social security benefit determinations. By implementing ARCH/GARCH models in policy practice authorities gain better predictive capabilities about volatility changes which supports confidence in making economic decisions. A globally interconnected economy benefits from these models which predict how outside disturbances such as oil price spikes or geopolitical disruptions trigger changes in domestic inflation rates (Jones et al., 2021). Through the incorporation of these forecasts' policymakers gain the ability to execute proactive economic protection actions that sustain ongoing economic development and stability.

5.2 Recommendations for Practitioners

Analysis of inflation using ARCH/GARCH models offers substantial benefits to economists and analysts due to these models' demonstrated strength in working with financial time series. When selecting models'

practitioners must conduct fit evaluation using AIC and BIC metrics alongside ensuring their data meets stationary requirements through appropriate preprocessing. The GARCH (1, 1) advanced model provides better forecasting outcomes because it includes volatility persistence functions in its structure.
The assessment of inflation relies on combining ARCH/GARCH predictions with data from economic determinants including workforce statistics and market commodity information to achieve complete forecasting. Analysts need to watch for two significant model weaknesses: the possibility of overfitting alongside outlier sensitivity (Smith & Taylor, 2020). Continuous testing with both inherent diagnostic signals and external validation of new samples helps maintain dependable forecast results.
Practitioners need to use programming languages including Python and R in addition to computational tools to both estimate parameters proficiently and create visual results. Model refinement experiences simplification through analytical tools which enable experts to concentrate on result analysis and data-informed decision making.

6.0 Conclusion

Research findings demonstrate that ARCH and GARCH models excel at USA inflation forecasting when the condition is marked volatility. These models capture conditional heteroskedasticity to overcome traditional forecast limitations while delivering essential accurate predictions for monetary and fiscal policy decisions. Data analysis reveals that the GARCH (1, 1) model best represents volatility clustering and persistence while achieving superior fit statistics than the ARCH (2) model.
While practical the study points out model instability may require substantial dataset volume as well as initial parameter sensitivities affect the research findings. Next generation research should combine machine learning methods with ARCH/GARCH models to improve prediction quality particularly in cases of non-linear patterns. The forecasting ability could benefit from wider inflationary influences examined alongside asymmetrical GARCH modeling approaches.
The ARCH and GARCH models stand as strong analytical methods for inflation analysis which impact stability decisions in economic environments. The adoption of such models provides decision-makers within both public sectors and private sectors powerful tools for making precise predictions about inflationary scenarios.

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