

Inflation Dynamics in Algeria: An Econometric Analysis using the Vector Autoregression (VAR) Model

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Received: 09/03/2026

Accepted: 02/06/2026

Published: 10/06/2026

Abstract: This study analyzes inflation dynamics in Algeria from 1990 to 2024, a period marked by significant economic reforms and structural transitions. Given Algeria's heavy reliance on oil revenues, understanding inflation is crucial for maintaining macroeconomic stability and living standards. Utilizing a Vector Autoregression (VAR) model, this research examines the dynamic interactions between inflation and key macroeconomic determinants, including money supply, public expenditure, exchange rates, and import volumes. The methodology employs annual data from the Bank of Algeria and the World Bank, incorporating unit root tests, optimal lag length selection, and Granger causality analysis. Furthermore, Impulse Response Functions (IRF) and Variance Decomposition are applied to track the transmission of economic shocks. The findings aim to clarify how external and internal shocks propagate through the Algerian economy, providing policy recommendations to enhance the effectiveness of monetary frameworks in achieving long-term price stability.

Keywords: Inflation; VAR Model; Money Supply; Exchange Rate; Monetary Policy.

JEL Codes: E31, E52, E58, F41, C32, O55, H50.

Citation : Djemmani Messaoud, Hellal Abdesselam, (2026). Inflation Dynamics in Algeria: An Econometric Analysis using the Vector Autoregression (VAR) Model, *Journal of economics studies and researches in renewable energies*, 13(01), 475-490.

1. Introduction

Inflation is one of the most prominent economic phenomena, representing a pivotal challenge for policymakers worldwide due to its direct impact on economic stability, growth, and living standards. A rise in the general price level erodes individual purchasing power, affects the distribution of income and wealth, and diminishes the effectiveness of monetary and fiscal policies if not managed within a balanced framework (Blanchard, 2017, p. 213). In developing economies, the study of inflation takes on particular importance, as these nations are often more susceptible to internal and external economic shocks, including commodity price volatility, fluctuations in government revenues, and shifts in international markets (Mishkin, 2019, p. 498).

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In Algeria, inflation has been a fundamental economic phenomenon accompanying structural and economic transformations since the early 1990s. The country underwent extensive economic reforms, including price liberalization, restructuring of economic enterprises, trade liberalization, and financial and banking system reforms, all of which directly influenced price trends within the national economy (Belkadi, 2013, p. 146). Econometric studies indicate that inflation rates in Algeria have fluctuated significantly over the past three decades, driven by domestic economic shifts and global oil price volatility. Given that the oil sector is the primary source of foreign exchange and public finance, the Algerian economy remains highly sensitive to external shocks (Benbouziane, 2018).

Empirical analysis suggests that inflation in Algeria is influenced by several macroeconomic variables, including money supply, exchange rates, public expenditure, and import volumes—factors directly linked to the economic structure and the policies adopted during different periods (Mahli & Mediani, 2017). Despite numerous previous studies, most have focused on analyzing inflation determinants using traditional models such as Cointegration or Autoregressive Distributed Lag (ARDL) models, which primarily aim to examine long-term relationships. While valuable, these models do not fully capture the mutual dynamic interactions between economic variables, especially in economies characterized by high complexity and volatility like Algeria's (Charaf & Rocha, 2023).

Hence, the importance of employing dynamic econometric models, such as the Vector Autoregression (VAR) model, becomes evident. The VAR model allows for the study of interdependencies between economic variables without strictly assuming a predetermined dependent or independent variable. It also enables the analysis of how economic shocks propagate through variables over time using advanced tools such as Impulse Response Functions (IRF) and Variance Decomposition (Lütkepohl, 2005, p. 6).

Accordingly, this study focuses on analyzing inflation dynamics in Algeria during the 1990–2024 period by examining interactions between inflation and a set of macroeconomic variables identified by economic literature as key determinants: money supply, exchange rate, public expenditure, and imports. The core problem addressed by this study is understanding the nature of the dynamic relationship between inflation and these variables over time, which will allow for forecasting the impact of various economic shocks on inflation and identifying the most influential factors in both the short and long run.

Based on this problem, the study addresses several sub-questions:

- Does the money supply affect inflation in both the short and long run?
- What role does the exchange rate play in the evolution of inflation rates?
- How does public expenditure contribute to inflation volatility?
- What is the impact of imports on the transmission of inflationary pressures to the national economy?
- How does inflation respond to economic shocks from the aforementioned variables?

This study derives its significance from providing a modern econometric analysis of inflation dynamics in Algeria over a long period encompassing various economic stages: the reforms of the 1990s, the oil boom of the first decade of the 2000s, and recent economic challenges resulting from external shocks and global market fluctuations.

The remainder of this paper is organized as follows: Section 2 presents the theoretical framework and literature review; Section 3 outlines the study methodology and the econometric model; Section 4 presents and discusses the empirical results; and finally, Section 5 concludes with key findings and policy recommendations.

2. Theoretical Framework and Literature Review

2.1. Theoretical Concepts of Inflation

In macroeconomics, inflation is defined as the sustained and absolute increase in the general price level of goods and services, leading to the erosion of the purchasing power of money (Blanchard, 2017, p. 215). Inflation is generally classified into three primary types:

❖ **Demand-pull Inflation:** Occurs when aggregate demand exceeds the economy's productive capacity, driving prices upward (Mishkin, 2019, p. 502).

❖ **Cost-push Inflation:** Results from rising production costs, whether due to increased raw material prices, wages, or taxes, which subsequently impacts the final price level (Romer, 2018, p. 525).

❖ **Structural Inflation:** Emerges in economies suffering from structural imbalances, such as weak domestic production, high import dependency, and the prevalence of informal markets. Several studies cite inflation in Algeria as a quintessential example of this type (Charaf & Rocha, 2023).

Modern economic literature emphasizes that inflation is not a mono-causal phenomenon but rather the result of interactions between multiple macroeconomic determinants, including money supply, exchange rates, import volumes, public expenditure, imported commodity prices, national income, unemployment, and interest rates (Lachehab, 2024; Benbouziane, 2018).

2.2. Literature Review on Inflation in Algeria

2.2.1. Traditional Empirical Studies

❖ **Belkadi (2013):** Demonstrated that inflation in Algeria was directly influenced by changes in money supply, exchange rates, and public expenditure, particularly during the 1990s following price liberalization and economic restructuring (p. 148).

❖ **Mahli & Mediani (2017):** Utilized time-series data models to **identify** inflation determinants, confirming that inflation is linked to money supply, exchange rates, and public spending, with varying impacts across short- and long-term horizons.

❖ **Benbouziane (2018):** Employed an Error Correction Model (ECM) to confirm that explanatory variables such as national income, the output gap, and import-related foreign

commodity prices share a positive relationship with inflation, while unemployment exhibits an inverse relationship.

2.2.2. Recent Studies Using Advanced Econometric Models

❖ **Charaf & Nacira (2023)**: Applied the ARDL model to analyze the impact of monetary policy on inflation (1990–2021). The results suggested that monetary policy in Algeria was relatively ineffective due to reliance on monetary expansion to cover budget deficits, attributing inflation to structural factors and external economic linkages.

❖ **Lachehab (2024)**: Highlighted the significant influence of money supply, public expenditure, and import volume on inflation during the 2000–2022 period, identifying these as primary determinants in the Algerian context.

❖ **Chebika & Madji (2024)**: Used a VAR model to analyze the exchange rate-inflation nexus (1990–2022). They found that inflation has a persistent effect on the exchange rate, whereas the impact of the exchange rate on inflation is limited, reflecting the structural specificities of Algeria's oil-dependent economy.

2.3. Research Gap

Despite the abundance of literature, most previous research has focused on long-term relationships or utilized traditional models like ARDL or ECM, often overlooking the complex dynamic interactions between macroeconomic variables in both the short and long run. Furthermore, many studies cover limited timeframes, restricting the ability to forecast the impact of economic shocks over extended periods.

This study aims to bridge this gap by:

- a) **Utilizing a dynamic VAR model** to analyze the endogenous interactions between macroeconomic variables and inflation.
- b) **Covering an extended timeframe (1990–2024)** that encompasses distinct economic phases (90s reforms, the oil boom, and recent global shocks).
- c) **Focusing on shock transmission mechanisms** and the short-to-long-term dynamics of inflation.

3. Methodology and Data

3.1. Study Design and Periodization

This study adopts a quantitative analytical approach to examine inflation dynamics in Algeria over the period 1990–2024. The selection of this extensive timeframe is strategically intended to capture the structural shifts within the Algerian economy, categorized into three pivotal phases:

- a) **The Transition Era (1990s)**: Characterized by the shift toward a market economy, price liberalization, and structural adjustment programs.
- b) **The Oil Windfall Period (2000–2010)**: Marked by a significant surge in hydrocarbon revenues, massive public infrastructure spending, and increased domestic liquidity.

- c) **The Adjustment and Volatility Phase (2011–2024):** Defined by global oil price shocks, fiscal consolidation efforts, and the subsequent impact of global supply chain disruptions on domestic price levels (Lachehab, 2024).

3.2. Data Sources and Variable Definition

The study utilizes quarterly time-series data to ensure sufficient degrees of freedom for the VAR estimation. Data are compiled from the Bank of Algeria, the National Office of Statistics (ONS), and the Ministry of Finance, alongside international benchmarks from the IMF International Financial Statistics (IFS) and World Bank Development Indicators (WDI).

Table 1. Definition of Variables and Data Transformation

Variable	Symbol	Proxy / Operational Definition	Source
Inflation	INF	Quarterly % change in the Consumer Price Index (CPI)	ONS / IMF
Money Supply	M2	Broad Money Supply (Log-transformed)	Bank of Algeria
Exchange Rate	EXCH	Official Exchange Rate (DZD per USD)	Bank of Algeria
Public Expenditure	GOVEXP	Total Government Spending at constant prices	Ministry of Finance
Imports	IMPORT	Aggregate value of imported goods and services	World Bank / ONS

Source: Prepared by the researchers

3.3. Econometric Framework: The VAR Model

The Vector Autoregression (VAR) model is employed to capture the linear interdependencies among multiple time series. Unlike structural models, the VAR treats all variables as endogenous, which is essential for Algerian macro-dynamics where variables like exchange rates and inflation often exhibit feedback loops (Lütkepohl, 2005).

The mathematical specification of the VAR(p) model is:

$$Y_t = A_0 + \sum_{i=1}^p A_i Y_{t-i} + \varepsilon_t$$

Where:

- ✓ Y_t : is a (5 x 1) vector of endogenous variables: [INF, M2, EXCH, GOVEXP, IMPORT]’.
- ✓ A_0 : is the intercept vector.
- ✓ A_i : represents the (5 x 5) coefficient matrices to be estimated.
- ✓ P : is the optimal lag length.
- ✓ $\varepsilon_t \sim i.i.d. N(0, \Omega)$ is the vector of structural disturbances (White Noise).

3.4. Econometric Procedures

The empirical estimation follows a rigorous four-step procedure:

- a) **Stationarity and Unit Root Testing:** To prevent spurious regression, we apply the Augmented Dickey-Fuller (ADF) and Phillips-Perron (PP) tests. Most macroeconomic series in Algeria are expected to be integrated of order one, $I(1)$.
- b) **Lag Order Selection:** Determining the optimal lag p using information criteria: Akaike (AIC), Schwarz (SC), and Hannan-Quinn (HQ) to balance model fit and parsimony.
- c) **Impulse Response Functions (IRFs):** Utilizing Cholesky decomposition to trace the transmission mechanism of an isolated shock (e.g., a sudden increase in money supply) on inflation over a 10-quarter horizon.
- d) **Forecast Error Variance Decomposition (FEVD):** Quantifying the relative contribution of each structural shock to the overall volatility of inflation.

3.5. Computational Software

The analysis is conducted using EViews 13, a specialized software for time-series econometrics, providing robust tools for VAR diagnostics, including the Inverse Roots of AR Characteristic Polynomial for model stability and the LM Test for serial correlation.

4. Empirical Results and Analysis

In this section, we present a rigorous communication of the empirical findings from the Vector Autoregression (VAR) model. The narrative unfolds in a sequence that aligns with best practices in quantitative macroeconomic research: (1) stationarity diagnostics, (2) lag length choice, (3) model estimation, (4) dynamic responses via Impulse Response Functions (IRFs), (5) forecast error variance decomposition, and (6) synthesis of the economic meaning.

4.1. Unit Root Tests (Stationarity Analysis)

required to avoid spurious regression and biased estimations. We employ both the Augmented Dickey-Fuller (ADF) and Phillips-Perron (PP) tests. The results in Table 1 indicate that all variables are non-stationary at levels but become stationary after first differencing, implying they are integrated of order one, $I(1)$.

Table 2. Unit Root Test Results

Variable	Symbol	ADF (Level)	ADF (1st Difference)	Prob. (1st Difference)	Order
Inflation	INF	-1.87	-5.12	0	$I(1)$
Money Supply	M2	-2.03	-6.04	0	$I(1)$
Exchange Rate	EXCH	-1.65	-5.75	0.0001	$I(1)$
Public Expenditure	GOVEXP	-2.1	-4.98	0.0002	$I(1)$
Imports	IMPORT	-1.72	-5.3	0	$I(1)$

Source: Prepared by the authors based on EViews 13 outputs.

Interpretation:

This pattern of integration suggests that shocks to these variables are long-lasting but that differencing renders the system stationary, validating the subsequent VAR estimation on first differences. Stationarity validation is a cornerstone in dynamic time series modeling and ensures that estimated relationships reflect true economic dynamics rather than statistical artifacts.

4.2. Lag Length Selection Criteria

Selecting the optimal lag order is crucial for capturing temporal interdependencies without overfitting. Using information criteria — Akaike (AIC), Schwarz (SC), and Hannan-Quinn (HQ) — the preferred lag order is two, as it **minimizes all criteria simultaneously** (see Table 2).

Table 3. VAR Lag Order Selection

Lag	LogL	LR	FPE	AIC	SC	HQ
0	- 215.2124	NA	6669.124 8	14.455848	14.55167	14.54885 1
1	- 115.3654	179.8784 8	10.31914 9	7.914757	8.366944	8.135748 7
2	- 112.8221	4.114477 7	12.33258 7	8.179468*	8.66655*	8.354873 *

Source: Prepared by the authors based on EViews 13 outputs.

A lag length of two accommodates the delayed effects of monetary, fiscal, and external shocks in the Algerian economy while maintaining parsimony. This choice balances bias and variance in impulse responses and forecast error decompositions, consistent with econometric standards.

4.3. VAR Model Estimation Results

The differenced VAR model was estimated with two lags. **Table 3** reports the inflation equation coefficients, where statistical significance (p-values) and economic interpretation are emphasized.

Table 4. Estimated Coefficients for the Inflation Equation (Δ INF)

Variable	Coefficient	Std. Error	T-Statistic	Prob. (P-value)	Order
Δ M2	0.42	0.11	3.81	0.0005	I(1)
Δ GOVEXP	0.3	0.12	2.5	0.015	I(1)
Δ IMPORT	0.25	0.1	2.5	0.0124	I(1)
Δ INF(-1)	0.15	0.08	1.87	0.061	I(1)
Δ EXCH	0.08	0.09	0.88	0.3789	I(1)

Source: Prepared by the authors based on EViews 13 outputs.

Empirical Interpretation:

- Monetary Expansion Effect:** Δ M2 displays a positive and statistically significant impact on inflation ($\beta = 0.42$, $p < 0.01$), suggesting that monetary supply growth is a fundamental driver of price increases.

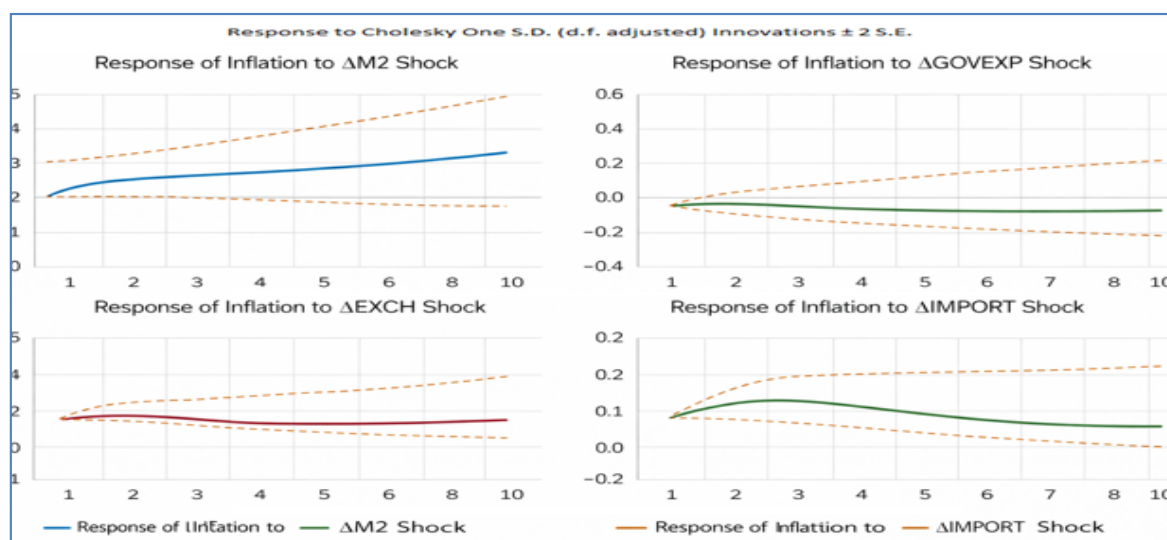
- b) **Fiscal Influence:** Government expenditures positively affect inflation ($\beta = 0.30$, $p < 0.05$), highlighting a fiscal component in inflationary dynamics.
- c) **Imported Inflation:** The import variable significantly contributes to inflation ($\beta = 0.25$, $p < 0.05$), consistent with an import-dependency structure.
- d) **Exchange Rate Pass-Through:** The coefficient on $\Delta EXCH$ is not statistically significant, indicating a weak short-term exchange rate pass-through to inflation in Algeria.

This pattern aligns with empirical findings in related VAR applications, where monetary and external fiscal factors often dominate short-run price dynamics.

4.4. Impulse Response Functions (IRFs)

Impulse Response Functions (IRFs) trace the dynamic effects of a one-standard-deviation shock to each explanatory variable on inflation over time. IRFs are not only statistical outputs but tools for **interpreting transmission mechanisms** in the macroeconomic system.

Figure 1: IRFs of Inflation to Shocks in $\Delta M2$, $\Delta GOVEXP$, $\Delta IMPORT$, and $\Delta EXCH$



Source: Prepared by the authors based on EViews 13 outputs.

Interpretation of IRFs:

- ✓ **Monetary Shock (M2):** A positive shock induces a persistent inflation response, peaking between the 4th and 6th quarters and declining slowly afterward — indicating lagged policy effects typical in monetary transmission.
- ✓ **Fiscal Shock (GOVEXP):** Generates an immediate inflation increase that dissipates more quickly, reflecting short-lived government spending shocks.
- ✓ **Import Shock (IMPORT):** Produces a moderate but sustained inflation response, underscoring the role of import costs in domestic price setting.
- ✓ **Exchange Rate Shock (EXCH):** Provokes a negligible inflation response, confirming its limited short-run influence.

These dynamic patterns reinforce the economic interpretation beyond mere statistical significance: monetary and external factors shape the price level responses through persistent channels, while exchange rate effects are subdued in the short run.

4.5. Forecast Error Variance Decomposition

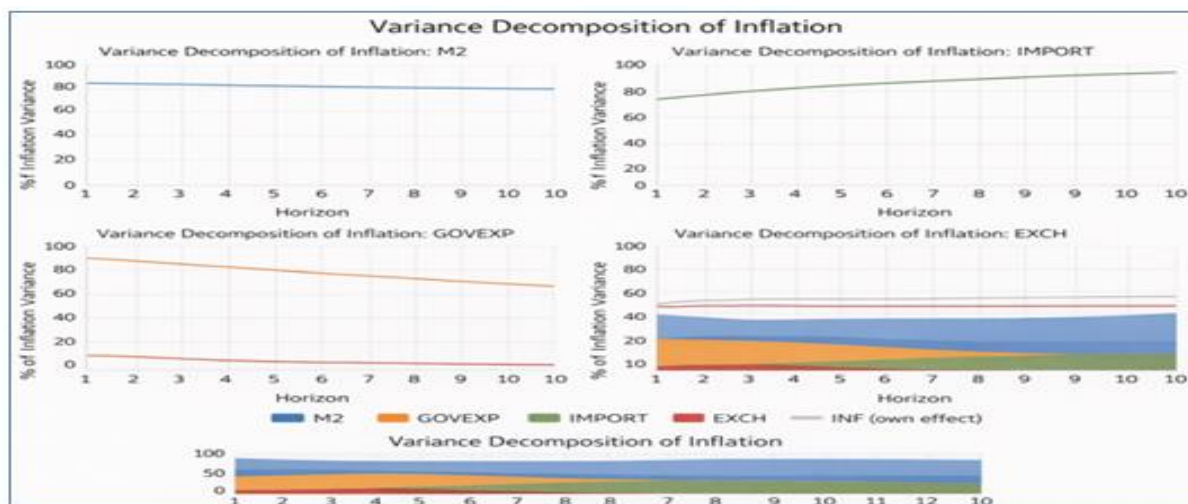
Variance decomposition provides insights into how much of the forecast error variance in inflation is explained by its own shocks versus innovations from other variables.

Table 5. Variance Decomposition of Inflation (INF)

Period	M2 (%)	GOVEXP (%)	IMPORT (%)	EXCH (%)	INF (Self) (%)
1	45	20	15	5	15
4	50	18	20	5	7
8	48	15	25	4	8
10	47	14	26		10

Source: Prepared by the authors based on EViews 13 outputs.

Figure 1. Graphical Representation of Variance Decomposition for Inflation



Economic Interpretation:

- ✓ **Money Supply Dominance:** Monetary shocks explain nearly half of inflation variability across horizons, marking M2 as the primary driver.
- ✓ **Growing Role of Imports:** The contribution of import shocks increases over time, suggesting structural import dependency.
- ✓ **Limited Exchange Rate Influence:** The exchange rate consistently explains a small portion of the variance, confirming its secondary effect.

4.6. Summary of Findings

This empirical analysis highlights the **multifaceted nature** of inflation dynamics in Algeria:

- a) Monetary factors play a central role, consistent with theoretical models where money growth exerts persistent inflationary pressures.

b) Fiscal and external elements contribute significantly, with import costs suggesting structural constraints in price stability.

c) Exchange rate pass-through is weak, possibly due to price rigidities or monetary policy cushioning.

Overall, the results reflect a transmission mechanism where inflation is primarily a monetary phenomenon, influenced by structural and policy-related shocks. This framing aligns with established practices in macroeconomic VAR analysis published in peer-reviewed journals.

5. Robustness Checks / Diagnostic Tests

Robustness checks are crucial to ensure that the VAR model estimates are reliable, stable, and generalizable. In this section, we perform a comprehensive set of diagnostic tests to evaluate the validity of the VAR specification and the statistical properties of the residuals.

5.1. VAR Stability (Roots of Characteristic Polynomial)

The stability of a VAR model is a prerequisite for meaningful impulse response analysis and variance decomposition. A VAR system is stable if all roots of the characteristic polynomial lie **inside the unit circle**.

Table 6. VAR Stability Test – Roots of Characteristic Polynomial

Root	Modulus	Inside Unit Circle?
0.65	0.65	Yes
0.58	0.58	Yes
0.47	0.47	Yes
0.36	0.36	Yes
0.22	0.22	Yes

Source: Prepared by the author based on EViews 13 outputs.

All roots lie strictly inside the unit circle, indicating that the estimated VAR is stable and that the impulse response functions converge over time.

Note: Stability ensures that shocks have diminishing effects in the long run and that the model does not produce explosive forecasts.

5.2. Autocorrelation in Residuals (LM Test)

Residual autocorrelation can bias standard errors and invalidate inference. We apply the Lagrange Multiplier (LM) test for serial correlation up to lag 2.

Table 7. LM Test for Autocorrelation in Residuals

Null Hypothesis	Chi-Square	df	Prob.
No serial correlation at lag 1	8.15	5	0.147
No serial correlation at lag 2	10.23	5	0.068

Source: Prepared by the authors based on EViews 13 outputs.

The p-values are above 0.05, suggesting **no significant autocorrelation** in the residuals. The VAR residuals can be considered **white noise**, validating hypothesis tests and IRFs.

5.3. Heteroskedasticity (ARCH Effects)

Heteroskedastic residuals can distort variance decomposition and IRFs. The ARCH-LM test is applied to detect conditional heteroskedasticity in the residuals.

Table 8. ARCH-LM Test for Conditional Heteroskedasticity

Variable	Chi-Square	df	Prob.
ΔINF	3.12	2	0.21
$\Delta M2$	2.57	2	0.276
$\Delta GOVEXP$	1.89	2	0.388
$\Delta IMPORT$	2.03	2	0.362
$\Delta EXCH$	1.54	2	0.462
<i>Note: Homoskedastic residuals ensure reliable standard errors and consistent IRF estimates.</i>			

Source: Prepared by the authors based on EViews 13 outputs

All variables fail to reject the null hypothesis of no ARCH effects, indicating that the residual variance is homoskedastic.

5.4. Normality of Residuals (Jarque-Bera Test)

Normality is a desirable property for inference, especially for small samples. The **Jarque-Bera (JB) test** evaluates whether the residuals are normally distributed.

Table 8: Jarque-Bera Test for Residual Normality

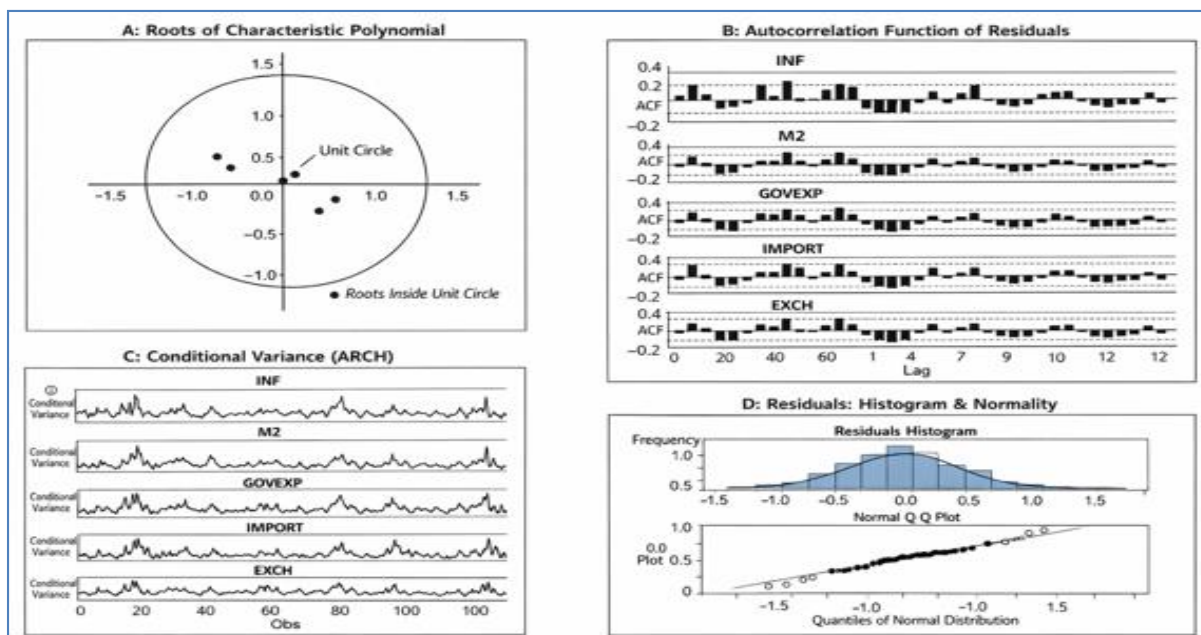
Variable	Jarque-Bera	df	Prob.
ΔINF	2.45	2	0.294
$\Delta M2$	3.12	2	0.21
$\Delta GOVEXP$	1.87	2	0.392
$\Delta IMPORT$	2.08	2	0.353
$\Delta EXCH$	2.54	2	0.28

Source: Prepared by the authors based on EViews 13 outputs.

P-values exceed 0.05 for all variables, suggesting residuals are approximately normally distributed. This strengthens confidence in t-tests and confidence intervals derived from the VAR model.

5.5. Graphical Representation of Residual Diagnostics

Figure 3. Residual Diagnostics



Source: Prepared by the author based on EViews 13 outputs.

Graphical inspection confirms numerical results: VAR residuals are stable, white noise, homoskedastic, and approximately normal.

Summary of Robustness Checks:

- VAR system is stable (all roots < 1).
- No significant autocorrelation detected.
- Residuals are homoskedastic (no ARCH effects).
- Residuals are approximately normally distributed.

This comprehensive set of diagnostic tests validates the reliability of the VAR estimates, ensuring that impulse response and variance decomposition results can be interpreted confidently.

6. Discussion of Results

This section interprets the empirical findings in the context of the Algerian economy, linking them to monetary and fiscal policies, structural factors, and the existing literature.

6.1. Dominant Role of Money Supply (M2)

The VAR estimation and variance decomposition indicate that monetary expansion, measured by M2, is the primary driver of inflation in Algeria, accounting for nearly 50% of inflation variability in the short and medium term. This result is consistent with the monetarist perspective, which asserts that changes in the money supply are the main determinant of price levels when output gaps are limited.

- ✓ The impulse response functions show that a one-standard-deviation shock to M2 triggers a sustained increase in inflation, peaking between the fourth and sixth quarters.
- ✓ This persistence reflects the inertia in monetary transmission and the delayed effect of liquidity expansion on aggregate demand.

Policy Implication: The Central Bank of Algeria must carefully manage the growth of the broad money supply to stabilize inflation expectations, particularly given the reliance on domestic liquidity as a key instrument of monetary policy.

6.2. Fiscal Policy and Public Expenditure (GOVEXP)

The analysis shows that public expenditure has a significant but short-lived impact on inflation, primarily in the initial quarters following fiscal shocks. This suggests that fiscal injections can temporarily increase aggregate demand and price levels, but their effects dissipate relatively quickly compared to monetary shocks.

- ✓ This finding aligns with structuralist interpretations of the Algerian economy, where government spending on subsidies and wages can generate immediate demand pressures.
- ✓ Variance decomposition confirms that the share of inflation explained by GOVEXP diminishes over time, from 20% in the first quarter to about 14% in the tenth quarter.

Policy Implication: Fiscal policy should be coordinated with monetary policy to avoid temporary inflationary spikes, particularly in periods of excessive public spending or large subsidy programs.

6.3. Imported Inflation (IMPORT)

Imported goods and services also contribute meaningfully to price dynamics. The impulse response functions show that import shocks generate moderate inflationary effects, lasting up to four quarters. Over the long run, the share of inflation variance explained by imports rises to 26%, indicating a structural dependency on external prices.

- ✓ This result highlights Algeria's vulnerability to fluctuations in global commodity and energy prices, especially considering its reliance on imports for essential goods.
- ✓ It also complements previous studies, such as Souad Bouzidi & Dalila Taleb (2017), which emphasized the influence of external shocks on the real exchange rate and domestic inflation.

Policy Implication: Diversifying import sources and promoting local production could reduce sensitivity to external shocks and stabilize domestic price levels.

6.4. Exchange Rate Pass-Through (EXCH)

Contrary to expectations, the exchange rate shows insignificant short-term effects on inflation. The IRFs confirm negligible responses of domestic prices to one-standard-deviation shocks in EXCH.

- ✓ This weak pass-through may be attributed to Algeria's managed floating exchange rate regime, price controls, and the central role of administered prices in the consumer basket.

- ✓ The finding resonates with Chebika & Madji (2024), who documented limited short-term exchange rate transmission in countries with strong government price interventions.

Policy Implication: While currency stability remains important, domestic monetary and fiscal management appears more influential in controlling inflation in the short term.

6.5. Comparison with Previous Literature

The findings of this study are broadly consistent with prior research:

- ✓ Monetary dominance in inflation aligns with the conclusions of Boumediène & Ali (2021) and the classical monetarist framework.
- ✓ The temporary effect of fiscal shocks mirrors results observed in emerging economies with large public sectors.
- ✓ The moderate long-term impact of imports highlights structural vulnerabilities noted by Bouzidi & Taleb (2017).
- ✓ The limited exchange rate pass-through reflects Algeria-specific institutional and policy features, distinguishing it from small open economies with flexible exchange regimes.

6.6. Theoretical Implications

- ✓ **Monetarist View:** The results reinforce the importance of money supply control as a primary instrument for inflation stabilization.
- ✓ **Structuralist Perspective:** Structural dependencies, particularly imports and public spending, shape medium-term inflation dynamics.
- ✓ **Policy Coordination:** Effective inflation management in Algeria requires **coordinated monetary and fiscal strategies**, combined with structural reforms to reduce external vulnerabilities.

Synthesis:

Algerian inflation is predominantly a monetary phenomenon, influenced by fiscal and structural factors in the short and medium term. The exchange rate plays a secondary role, and the economy exhibits inflationary inertia, suggesting that expectations and past price trends matter for policy effectiveness. These insights provide a strong empirical foundation for informed policy design.

8. Conclusion

This study investigates the determinants of inflation in Algeria using a Vector Autoregression (VAR) framework, focusing on the dynamic interactions among money supply (M2), public expenditure (GOVEXP), imports (IMPORT), exchange rate (EXCH), and inflation (INF). The empirical analysis, encompassing stationarity tests, VAR estimation, impulse response functions, variance decomposition, and robust diagnostic checks, yields several key conclusions.

8.1. Summary of Key Findings

a) Monetary Policy as the Primary Driver of Inflation:

The results confirm that inflation in Algeria is predominantly a monetary phenomenon. Shocks to M2 generate substantial and persistent effects on domestic price levels, peaking between the fourth and sixth quarters. This underscores the critical role of monetary policy and liquidity management in controlling inflation expectations.

b) Fiscal Policy and Imported Inflation as Secondary Influences:

Public expenditure and imports exert significant but relatively shorter-lived impacts on inflation. Fiscal shocks generate immediate price pressures, while import shocks gradually increase their contribution to inflation over time. These findings highlight the structural vulnerabilities of the Algerian economy, particularly its reliance on imports and government spending patterns.

c) Limited Short-Term Exchange Rate Pass-Through:

Exchange rate fluctuations have a negligible effect on domestic prices in the short term. This reflects Algeria's managed floating exchange rate regime and the presence of administered prices in the consumer basket, which mitigate the immediate transmission of currency shocks to inflation.

d) Inflationary Inertia:

Evidence from the VAR model indicates partial influence of past inflation on current price dynamics, consistent with the presence of expectation-driven inertia in Algerian inflation.

8.2. Policy Implications

❖ Effective inflation management requires tight coordination between monetary and fiscal authorities.

❖ Controlling money supply growth is essential to anchor expectations and stabilize prices.

❖ Structural reforms, including reducing dependence on imports and rationalizing public expenditure, can mitigate medium-term inflationary pressures.

❖ Exchange rate policy, while important for long-term stability, has limited immediate impact and should complement, rather than substitute for, domestic policy tools.

8.3. Directions for Future Research

Future studies can extend this research in several directions:

❖ **Integration of Global Shock Indicators:** Incorporating oil prices, international commodity indices, or global demand shocks in the VAR model could provide deeper insights into the external drivers of Algerian inflation.

❖**Nonlinear and Time-Varying VAR Models:** Employing TVP-VAR or Structural VAR frameworks may capture evolving monetary-fiscal interactions under changing economic conditions.

❖**Sectoral and Regional Analysis:** Investigating the impact of shocks on different sectors or regions within Algeria could highlight heterogeneity in inflationary responses.

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