Accepted Manuscript

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PII: S0165-1889(17)30239-7
DOI: 10.1016/j.jedc.2017.11.006
Reference: DYNCON 3494

To appear in: *Journal of Economic Dynamics & Control*

Received date: 25 May 2017
Revised date: 21 November 2017
Accepted date: 21 November 2017

Please cite this article as: Ayşe Kabukçuoğlu, Enrique Martínez-García, Inflation as a Global Phenomenon—Some Implications for Inflation Modelling and Forecasting, *Journal of Economic Dynamics & Control* (2017), doi: 10.1016/j.jedc.2017.11.006

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Inflation as a Global Phenomenon—Some Implications for Inflation Modelling and Forecasting

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First draft: September 25, 2015
This draft: November 20, 2017

Abstract

We model local inflation dynamics using global inflation and domestic slack motivated by a novel interpretation of the implications of the workhorse open-economy New Keynesian model. We evaluate the performance of inflation forecasts based on the single-equation forecasting specification implied by the model, exploiting the spatial pattern of international linkages underpinning global inflation. We find that incorporating cross-country interactions yields significantly more accurate forecasts of local inflation for a diverse group of 14 advanced countries (including the U.S.) than either a simple autoregressive model or a standard closed-economy Phillips curve-based forecasting model. We argue that modelling the temporal dimension—but not the cross-country spillovers—of inflation does limit a model's explanatory power in-sample and its (pseudo) out-of-sample forecasting performance. Moreover, we also show that global inflation (without domestic slack) often contributes the most to achieve the gains on forecasting accuracy observed during our sample period (1984:Q1-2015:Q1)—this observation, according to theory, is crucially related to the flattening of the Phillips curve during this time period of increased globalization.

JEL Classification: C21; C23; C53; F41; F47; F62.

KEY WORDS: Inflation Dynamics; Open-Economy Phillips Curve; Forecasting.

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