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# Inflation differentials among the Euro area countries: Potential causes and consequences<sup>☆</sup>

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## Abstract

In this paper we review the development, potential causes and macroeconomic implications of inflation differentials in the euro area. We also present some new evidence based on an estimated New Keynesian style model of the euro area economies. Our empirical analysis suggests that the observed inflation differentials since the start of EMU were mainly driven by temporary shocks combined with a rather high level of inflation persistence. The scope for an amplification of inflation differentials via corresponding real interest rate differentials appears to be limited by the presence of significant real exchange rate and direct output spill-over effects in the euro area IS Curves. We also find that inflation persistence is significantly lower, virtually zero, in the group of euro area countries which have already experienced comparably low and stable inflation rates in the past. Since the monetary policy of the Eurosystem is geared at delivering and maintaining low and stable inflation rates, inflation persistence should also decrease in the other countries, which would in turn mitigate the persistence of euro area inflation differentials.

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## 1. Introduction

The optimum currency area (OCA) literature identifies several conditions that must at least in part be met for a currency union to be viable.<sup>1</sup> One of them is sufficient similarity in the national rates of inflation. This precondition is necessary since in a currency union nominal exchange rates are irrevocably fixed, and therefore, external imbalances building up in the wake of persistent divergences in national inflation rates cannot be corrected by an exchange-rate realignment.

However, since the start of EMU, persistent differentials in national price developments continue to exist in the euro area. The accumulated effect of these differentials is already reflected in quite significant shifts in real exchange rate indicators of some of the euro area countries. Besides the implications of inflation differentials for external price competitiveness, some commentators have recently also uttered concern that these inflation differentials may also give rise to self-exciting internal imbalances. Since all countries face the same short-term nominal interest rate set by the Eurosystem, persistent inflation differentials across euro area countries will give rise to equally persistent short-term real interest rate differentials. As a result, some experts are of the opinion that the Eurosystem's monetary policy may be overly tight for countries already experiencing low inflation and excessively loose for countries experiencing high inflation rates.

As the Eurosystem's mandate is to safeguard price stability in the euro area as a whole, it will not base its monetary policy decisions on inflation developments in single countries and will take them into consideration only to the extent they influence the aggregate figures for the euro area. Besides, the Eurosystem does not dispose of any instruments to selectively address inflation developments in single member countries. However, persistent inflation differentials may at one point impair public acceptance of EMU and may eventually put the viability of monetary union at risk if they do not prove to be self-correcting, especially since the monetary union is not backed by a political union. For this reason, understanding the causes of the observed inflation differentials and the adjustment mechanisms at work amplifying/limiting their spread is of major importance. In this paper we address both issues by reviewing the existing literature and presenting some new evidence. The plan of the paper is as follows: In Section 2 we review the development of inflation dispersion in the euro area since the start of EMU in historical and international perspective. In Section 3 we assess the potential causes of the observed inflation differentials in the euro area. In Section 4 we analyse the significance of the various potential causes of inflation differentials and their macroeconomic implications in a stylised New Keynesian model of the euro area countries. Section 5 concludes.

## 2. Inflation dispersion in the euro area

In the run-up to EMU in the 1990s, inflation dispersion in the euro area has declined substantially. Fig. 1 shows the development of the unweighted cross-country standard deviation<sup>2</sup>

<sup>1</sup> See Mongelli (2002) for an overview.

<sup>2</sup> Besides the unweighted standard deviation, alternative measures of inflation dispersion are the weighted cross-country standard deviation, the maximum span of inflation rates and the coefficient of variation. All these alternative dispersion measures give a very similar picture of inflation dispersion in the euro area and its evolution over time.

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