

# **DETERMINANTS OF INFLATION DIFFERENTIALS IN THE EURO AREA: IS THE NEW KEYNESIAN PHILLIPS CURVE ENOUGH?**

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Submitted December 2014; accepted May 2016

In the euro area, inflation rates diverged after the creation of the single currency, and started to converge again from mid-2002. It is against this background that the paper studies the determinants of inflation differentials in the euro area. We start by using the New Keynesian Phillips Curve (NKPC) to explain inflation differences for a panel of countries. Exchange rate movements and expected inflation in particular play an important part in bringing about diverging inflation dynamics, while lagged inflation does not. The Incomplete Competition Model (ICM) adds explanatory power to the NKPC in describing inflation dynamics across countries. The latter model does not encompass ICM, and the variables proposed by the ICM are statistically significant: the growth in nominal Unit Labour Cost and the long-run disequilibrium between prices and costs explain inflation differentials.

*JEL classification codes:* C23, E12, E31, F41

*Key words:* inflation, business cycles, convergence, New Keynesian Phillips Curve, Incomplete Competition Model

## **I. Introduction**

Since the creation of the European Exchange Rate Mechanism (ERM) in 1979, monetary and financial convergence in the euro area has been accompanied by inflation convergence. However, some inflation divergence did occur after the introduction of the euro (Lane 2006; Busetti et al. 2007), as can be observed in

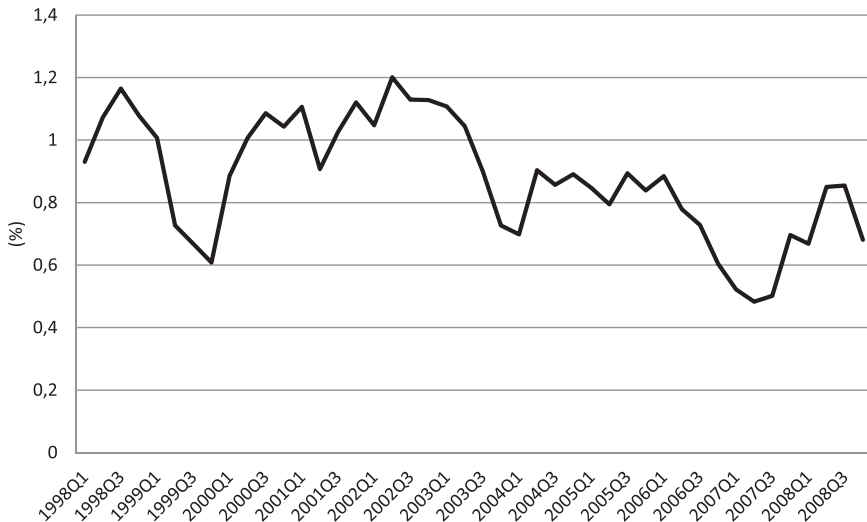
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Figure 1. Due to the nominal convergence effort before the creation of the euro, the cross section standard deviation of inflation rates in the euro area decreased to 0.6% in the fourth quarter of 1999.<sup>1</sup> Subsequently, inflation differentials increased to 1.2% in the second quarter of 2002. After this peak, inflation dispersion decreased again to the lowest level ever observed of 0.48% in the second quarter of 2007. In the first years of the euro (1999-2002), Greece, Ireland, the Netherlands, Portugal and Spain had the highest inflation rates.

As highlighted by the Optimum Currency Area literature, large inflation differentials may undermine the success of a monetary union. Differences in inflation rates can be caused by temporary asymmetric shocks, such as demand shocks, but the ability to deal with these impacts is limited in the absence of a national monetary policy. Inflation differentials cannot be corrected by nominal currency depreciation of high-inflation countries. Although countries may use expansionary fiscal policy to solve the problem of deflationary shocks, this can lead to a violation of the

Figure 1. Cross section standard deviation of inflation rates after 1998



Source: authors' calculations based on Eurostat data.

<sup>1</sup> In the empirical results of this paper, "euro area" only refers to 12 countries, the original 11 plus Greece: Austria, Belgium, Finland, France, Greece, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. Data: annual inflation rates based on quarterly CPIs:  $(p_t/p_{t-4}) \cdot 100$ . For each quarter, we obtained the standard deviation for the group of 12 countries.

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