

Inflation, Inflation Uncertainty, and a Common European Monetary Policy*

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Abstract

The relationship between inflation and inflation uncertainty is investigated in six European Union countries for the period 1960 to 1999. EGARCH models are used to generate a measure of inflation uncertainty and then Granger methods are employed to test for causality between average inflation and inflation uncertainty. In all the European countries, except Germany, inflation significantly raises inflation uncertainty as predicted by Friedman. However, in all countries except the UK, and possibly Italy, inflation uncertainty does not cause negative output effects implying that a common European monetary policy applied by the ECB might not lead to asymmetric real effects via the inflation uncertainty channel. Less robust evidence is found regarding the direction of the impact of a change in inflation uncertainty on inflation. In Germany, the Netherlands, and to a lesser extent Spain, increased inflation uncertainty lowers inflation while in the UK, Italy, and to a lesser extent France, increased inflation uncertainty raises inflation. These results are generally consistent with the existing rankings of Central Bank Independence.

Keywords: EMU, Exponential GARCH, Inflation, Inflation Uncertainty

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