

Abstract

In this paper, we empirically investigate the link between exchange rate accommodation and inflation persistence in Europe. We introduce the lagged level of the real exchange rate as an appropriate indicator of exchange rate accommodation. We correspondingly estimate a non-linear autoregressive inflation equation for ten European countries (excluding Germany) for the period 1974:1-1998:2. In the estimation procedure we allow for the presence of an unknown number of shifts in the mean of inflation. Our results provide supportive evidence for the existence of a positive link between exchange rate accommodation and inflation persistence for the smaller and more dependent ERM countries. No such link could be detected for the larger countries and the countries that remained outside the ERM for most of the period. Overall, our results provide modest support for the existence of the theoretically hypothesized link between exchange rate accommodation and inflation persistence