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No. 2007/01

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**Regional Inflation Dynamics within and  
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Comparison with the US \***

Günter W. Beck<sup>1</sup>, Kirsten Hubrich<sup>2</sup>,  
and Massimiliano Marcellino<sup>3</sup>

This Version  
September 2006

**Abstract:**

We investigate co-movements and heterogeneity in inflation dynamics of different regions within and across euro area countries using a novel disaggregate dataset to improve the understanding of inflation differentials in the European Monetary Union. We employ a model where regional inflation dynamics are explained by common euro area and country specific factors as well as an idiosyncratic regional component. Our findings indicate a substantial common area wide component, that can be related to the common monetary policy in the euro area and to external developments, in particular exchange rate movements and changes in oil prices. The effects of the area wide factors differ across regions, however. We relate these differences to structural economic characteristics of the various regions. We also find a substantial national component. Our findings do not differ substantially before and after the formal introduction of the euro in 1999, suggesting that convergence has largely taken place before the mid 90s. Analysing US regional inflation developments yields similar results regarding the relevance of common US factors. Finally, we find that disaggregate regional inflation information, as summarised by the area wide factors, is important in explaining aggregate euro area and US inflation rates, even after conditioning on macroeconomic variables. Therefore, monitoring regional inflation rates within euro area countries can enhance the monetary policy maker's understanding of aggregate area wide inflation dynamics.

**JEL Classification:** E31, E52, E58, C33

**Keywords:** Regional Inflation Dynamics, Euro Area and US, Common Factor Model

\* We thank Guenter Coenen, Gabriel Fagan, Tohmas Karlsson, Lutz Kilian and Lucrezia Reichlin, seminar participants at the European Central Bank and the Dutch Central Bank as well as participants of the CEF 2006 and the EEA-ESEM 2006 conferences for helpful comments. The usual disclaimer applies. The views expressed in this paper are those of the authors and do not necessarily reflect those of the European Central Bank.

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# 1 Introduction

It is highly important for the conduct of the ECB's monetary policy to investigate whether and to what extent heterogeneity of inflation and growth within the euro area has been declining due to the higher integration of labour, product and capital markets in the advent to the European Monetary Union (EMU) and after the introduction of the euro in 1999. In this context it is of interest to analyse regional inflation dynamics within as well as across euro area countries on a disaggregated level. Since large and persistent differences in regional inflation rates might lead to contradicting demands concerning the conduct of monetary policy,<sup>1</sup> it is essential for policy makers to understand how and to what extent differences between inflation rates arise.

Co-movements and heterogeneity in inflation rates on a regional level have not been analysed systematically so far. We therefore investigate how and to what extent differences in inflation rates across different regions arise within as well as across national borders of euro area countries. The analysis of our new disaggregate regional data set is facilitated by new developments in factor analysis as a tool for the analysis of large data sets. The analysis in this paper shows that using regional data provides additional important insights that cannot be revealed by more aggregate area wide or country information.

The issue of how inflation differentials arise in monetary unions and when they should have implications for monetary policy has been recently addressed theoretically by several authors. Based on the framework developed by Obstfeld & Rogoff (1995, 2000), Duarte & Wolman (2002) and Altissimo, Benigno & Palenzuela (2005) build an open economy model including both a traded and non-traded sector and use it to analyse inflation differentials in the euro area. They find that fiscal measures and productivity differentials are an important source for inflation differentials within the euro area.

However, there is - to our knowledge - no theoretical framework that considers inflation differences between regions within a country. Instead, 'region' in the existing literature usually refers to euro area countries or to areas covering a number of countries. The models in the theoretical literature cited above provide a framework that is in some important aspects not appropriate for our analysis. To analyse regional inflation differentials within countries, we need a model in which, for example, the majority of fiscal policy decisions and decisions on institutional structures and regulations are taken on a different level of aggregation as inflation dynamics are determined and where heterogeneity of agents' reaction to common area wide and national developments and shocks within national borders is allowed, not only between two different countries. Knowledge on regional inflation developments is very limited

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<sup>1</sup>For this argument, see e.g. Cecchetti, Mark & Sonora (2002) in their analysis of price index convergence of US cities.

so far. With this paper we establish some stylised facts on co-movements and heterogeneity of regional inflation rates within the European Monetary Union and compare those with regional inflation dynamics in the US, a long-established currency area. Our findings might stimulate new theoretical research in this area.

Our analysis focusing on regional inflation complements the literature on euro area inflation dynamics and convergence (see e.g. Engel & Rogers (2004), Beck & Weber (2005), Hubrich (2005) and Hendry & Hubrich (2006) and Marcellino, Stock & Watson (2003)). We shed additional light on inflation dynamics and on the issue of the effect of EMU on inflation rates in the euro area, not only across countries or sectors but also across regions.

We have collected a unique data set on prices, real variables and structural variables for a large number of regions within euro area countries, covering a large part of the euro area. Motivated by a pricing model for regional goods we employ a factor model framework to decompose regional inflation rates into euro area, national and regional components, similar to Forni & Reichlin (2001) in their analysis of output fluctuations in the euro area and the US. One aim of our paper is to explore the strength of co-movements among all regional inflation rates on the area wide and the national level. First, we analyse whether there exists an area wide common component due to the convergence process towards European Monetary Union implying similar monetary policy of national central banks in Europe, the common monetary policy in the euro area since 1999 as well as due to external developments. Second, country-specific factors might arise due to fiscal policy measures, such as changes to unemployment benefits or tax changes, price liberalisation measures, administrative price changes, and more generally through institutional structures including product market regulations and financial market regulations. Third, other special economic factors may lead to divergencies of inflation rates are production structures, trade patterns and labour market institutions. However, for the latter three characteristics it is less clear whether they are country-specific or whether they are related to regions that represent only a part of a country or that reach across national borders. For example, although there might be some general wage bargaining process for a country as a whole, recently more regional and/or sector-specific wage agreements occur. A region specific inflation component might also be due to low labour market mobility creating different labour market conditions across regions, e.g. between the East and the West of Germany or the North and the South of Italy. It is also conceivable that the effects of measures taken at the national or area wide level can differ across regions. We also investigate the relative importance of common developments for the regions.

Recent developments in factor analysis allow the estimation of our model for regional inflation even in the presence of a rather short temporal dimension of the sample given a rather large cross-sectional dimension. Specifically, we employ principal component based estima-

tors for the factors, along the lines of Stock & Watson (2002b). While more sophisticated estimation techniques are available, see e.g. Forni, Hallin, Lippi & Reichlin (2000, 2005), the differences are usually minor both in simulation experiments and in empirical applications, see e.g. Kapetanios & Marcellino (2004), Favero, Marcellino & Neglia (2005), although this will depend on the unknown data generating process.<sup>2,3</sup> An additional advantage of the principal components in our context is that the estimated factors are linear combinations of current regional inflation rates only - while the other estimation methods involve leads and lags. This simplifies their interpretation.

In Section 2 we describe the regional data set we have prepared for this paper, present some key descriptive statistics and discuss their implications. The data set contains monthly series from 1995(1) to 2004(10) for Austria, Finland, Germany, Italy, Portugal and Spain, covering about 2/3 of the euro area in terms of economic activity. For the other euro member countries, regional data are either not available or their collection started only very recently. We also describe the disaggregated US data set that we have collected to compare our findings for the euro area with those for a long-established currency area.

In Section 3 we present more formally the economic motivation for our analysis and the econometric framework based on factor analysis. In the Appendix we explain and evaluate an alternative approach to modelling regional inflation dynamics based on macro variables along the lines of the global VAR analysis by Peseran, Schuerman & Weiner (2004), which appears not to perform as well as the factor based method for our regional data set.

The subsequent empirical analysis presented in Section 4 focuses on the area wide and national components in regional inflation rates and involves three stages. First, we estimate the area wide factors based on all regional inflation rates. We find one main factor explaining about 50% of the variability in the data. The first three area wide factors, common to all regions, explain about 75% of the variability in regional inflation data, suggesting important commonality across all regions. We postulate that these factors are related to common demand developments within the euro area, mostly related to monetary policy, to changes in oil prices that might in recent years be related to supply as well as demand effects, or to external developments, related to exchange rate movements.

At the second stage of our analysis, we estimate the country specific factors, based on the principal components of the residuals of the regression of each of the regional inflation rates

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<sup>2</sup>For further comparisons between the different factor approaches, see e.g. Boivin & Ng (2005) and D'Agostino & Giannone (2006).

<sup>3</sup>A somewhat related methodological approach to ours is chosen by Kose, Otrok & Whiteman (2003). They analyse the common dynamic properties of business cycles using a Bayesian dynamic latent factor model. Their focus is to investigate the existence of a common world factor and the role of factors common to a group of countries. Similarly, Ciccarelli & Mojon (2005) investigate the existence of a world factor driving the inflation rates across countries.

on the euro area factors. Our results show that three country-specific common factors explain at least 65% of the remaining variability in regional inflation, also in the large countries.

In the third step we regress regional inflation rates on the estimated area wide and national factors, finding that both types of factors are strongly significant and that the model explains a large part of the variability in regional inflation, and it appears to be correctly specified for most regional inflation series from a statistical point of view.

We also evaluate whether the area wide factors have the same effects across all regions. We find that this is not the case and relate the variance explained by the area wide factors to structural economic characteristics of the respective region.

In Section 5 we examine the robustness of our results with respect to the number of area wide and national factors used. We also evaluate three additional aspects of regional inflation dynamics. First, we consider whether regional inflation is better explained by area wide inflation than by the area wide factors, but this turns out not to be the case. Moreover, when area wide inflation is used as a regressor there is a spurious increase of about 25% in our measure of regional inflation persistence.

Second, the analysis discussed in the main text is based on the level of inflation. If inflation were actually so persistent as to be integrated of order one, we might find a lower number of factors to be relevant when analyzing the level of regional inflation, since stationary factors would be more difficult to detect see (see Bai & Ng, 2002). Therefore, we repeat the full analysis for changes in inflation to investigate the sensitivity of our results toward the stationarity assumption for inflation, finding that the main results do not change.

Third, we consider explicitly the effects of the introduction of the euro. The question arises whether regional inflation dynamics differ after the introduction of the euro in comparison with the period before the start of the European Monetary Union (EMU). Split sample analysis for the pre- and post-1999 period reveals a limited impact. However, this could be due to the fact that the EMU was announced well before 1999 so that the convergence process could have mostly taken place by 1995, the starting date of our sample.

Section 6 compares the results for the euro area with those for the US, employing data from US metropolitan areas. We find that the first common factor explains a similar amount of variability of regional inflation in the US as in the euro area, and that US regional inflation dynamics are also well explained by the factor based representation.

Section 7 investigates the question to what extent aggregate euro area and US inflation can be explained by the area wide factors extracted from the regional data set. We find that in both cases the area wide factors are important explanatory variables in addition to standard aggregate macro variables such as labour market or monetary variables. This result suggests that area wide factors derived from regional inflation data capture additional aspects

relevant at the aggregate level in addition to the information captured by the aggregate macroeconomic variables we consider, and provides a further justification for monitoring regional inflation dynamics.

Finally, in Section 8 we summarize the main findings of the paper and discuss their implications for the conduct of monetary policy.

## 2 Regional inflation data

For our study we collected a large set of European regional consumer price data. The data set contains consumer price index (CPI) data from six EMU member countries and comprises a total of 70 locations. These data cover about 2/3 of the euro area in terms of economic activity and span the period 1995(1) to 2004(10) on a monthly frequency. For the remaining euro area countries comparable regional data are not available or at least not for a similar time span. An overview of the countries and regions that are included in our study (and their shortnames) is given in Tables 1 and 2. More specifically, we are using price data for 12 German states ('Länder'), 9 Austrian regions, 5 Finnish regions, 19 Italian cities, 18 Spanish regions ('comunidades'), and 7 Portuguese regions. In all cases the regions correspond to NUTS-II regions, except for Germany where only data for NUTS-I regions are available. The Nomenclature of Territorial Units for Statistics (NUTS) was established by Eurostat in order to provide a single uniform breakdown of territorial units for the production of regional statistics for the European Union. Statistical Regions are defined at three levels: NUTS I, NUTS II, and NUTS III where NUTS III corresponds to the most detailed level of regional disaggregation. As data for Austria were only available at a city level we compiled NUTS-II level data for Austrian regions by computing a weighted regional CPI index. Weights were given by the number of inhabitants of the respective cities. Data for Italy were available for a sufficiently long time period only for the main city in each of the NUTS II regions. As Table 1 indicates, all data were provided either by a country's national statistical office (Austria, Finland, Italy, Spain and Portugal) or by the respective region's statistical office (Germany).

All data are monthly, non-seasonally adjusted and are available in index form. Inflation rates  $\pi_t$  are computed as year-on-year percentage changes in the price index in the following way:

$$\pi_t = 100 * (\ln P_t - \ln P_{t-12}), \quad (1)$$

where  $P_t$  represents the respective price index in month  $t$ . Year-on-year inflation rates are reported in Figures 1 and 2.

Figure 1 also illustrates the importance and extent of regional inflation rate dispersion



for our sample. Regional dispersion is considerable, spanning a band of around 4 percentage points. Additionally, one can observe that there does not seem to be a tendency for overall inflation dispersion to decrease over time (no  $\sigma$ -convergence). Table 3 provides some descriptive statistics. Looking at the mean inflation rates, we can see that the lowest average inflation rate over the sample period prevailed in Germany, followed by Finland, Austria, Italy, Portugal, and Spain (in that order). Notice also that the average national inflation dispersion (about 1.5 percentage points) is considerably smaller than the regional dispersion that we saw in Figure 1 (about 4 percentage points). Looking at the reported cross-sectional dispersion measures (measured by the standard deviations of regional mean inflation rates), we can see that dispersion at a national level is lower than at the EMU level. Nevertheless, dispersion is still important also at the national level. This indicates that regional data might contain information that is not available in national data only.

When we split the sample into a ‘pre-EMU’ (1996(1) - 1998(12)) and an ‘EMU’ (1999(1) - 2004(10)) subsample, two major observations can be made. First, mean inflation rates are always lower in the ‘pre-EMU’ subperiod (see Table 3). Second, inflation dispersion remains more or less stable across the two subperiods, in line with the visual impression from Figure 1. The first observation probably reflects the large efforts of EMU countries to meet the Maastricht criteria before 1999. The second observation shows that, despite substantial harmonization efforts, considerable heterogeneities across EMU regions continue to exist.

Table 4 contains Augmented Dickey Fuller (ADF) unit root test results for the regional inflation rate series. As is well-known, the power of single-equation unit root tests is low in small samples. Since our sample period for year-on-year inflation (1996(1) - 2004(10)) is very short, it is probably not very surprising that for only about 25% of the regions the null hypothesis of a unit root can be rejected. We also report results from applying a variety of recently developed panel unit root tests. As the lower panel of Table 4 shows in all tests the null hypothesis of non-stationarity is clearly rejected.<sup>4</sup> Given the low power of the single-equation unit root tests and given the results from the panel-unit root tests we will base most of our analysis on inflation level data rather than first differences. However, as a sensitivity check we will also repeat the analysis for first differences (see Section 5.3).

Finally, to benchmark and compare our results with a long-established common currency area, we collected regional consumer price indices for the US. A more detailed description of these data is given in Section 6.

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<sup>4</sup>Please note, however, that these tests might not be well suited in our context due to the substantial comovement across regional inflation rates, evident from Figure 1, which would bias the tests substantially, see Banerjee, Marcellino & Osbat (2005).

### 3 Economic motivation and econometric framework

To motivate our analysis of the different factors behind regional inflation developments we first outline a simple model to illustrate of how we think that prices in different locations are determined. This model is meant to serve as a point of reference for our empirical findings in the next sections. We do not intend to present a full-scale DSGE model which is beyond the scope of the paper.

Assume that in each location  $i$  of a certain country  $j$  (where  $j = 1, 2, \dots, J$  and  $i = 1, 2, \dots, N_j$ ) there is a monopolistic producer of a final good, i.e. the producer has price setting power. The final good is assumed to be nontraded to allow for price differentiation across regions. This assumption might be justified by considering the marketing and distribution services to be region specific.<sup>5</sup> The final good is produced using two intermediate inputs, of which one is traded and one is nontraded. The latter element can be thought to be the marketing service that accompanies the sale of the good and which accounts, according to Anderson & van Wincoop (2003), for the dominant part of the good's final price. Given that the production technology is Cobb-Douglas, the final price of the good in location  $i$  in country  $j$ , denoted by  $P_{ij}$ , is then given by:

$$P_{ij} = (1 + \tau_{ij})\beta_{ij}\alpha_{ij} (Q_{ij}^{NT})^\gamma (Q_{ij}^T)^{1-\gamma}. \quad (2)$$

In this equation,  $\tau_{ij}$  represents the value-added tax rate of country  $j$ . Value-added taxes in euro area countries are set at the national level, i.e. we have  $\tau_{hj} = \tau_{ij} \forall h, i = 1, 2, \dots, N_j$ .  $\beta_{ij}$  represents the markup over costs which is inversely related to the elasticity of demand. Since market conditions vary across geographically segmented markets, we assume  $\beta_{ij}$  to be a region specific parameter.  $\alpha_{ij}$  represents the total productivity of the final-goods sector related to the technological progress and human capital, that we therefore also assume to be region specific.

$Q_{ij}^{NT}$  represents the price of the nontraded input for the production of the final good. The nontraded input essentially represents assembly as well as marketing and distribution services associated with the sale of the good. This component is very labor intensive and therefore we assume  $Q_{ij}^{NT}$  to a large extent reflect wage costs.  $Q_{ij}^{NT}$  might also be influenced by rents which can differ significantly across locations. Both wage costs and rents are to a large degree determined locally. It should be noted though, that it is also conceivable that wage dynamics have a considerable nation-wide component. This is particularly true for those countries in our sample for which centralisation of the wage bargaining process is still

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<sup>5</sup>Note that we abstract from transaction costs that would otherwise allow the assumption of a nontraded final good to be relaxed.

relatively strong (such as Germany or Austria).

$Q_{ij}^T$  represents the price of the traded input for the production of the final good. We assume that the LOOP holds across markets, such that  $Q_{ij}^T = Q_{l,m}^T = Q^T$  (for  $j \neq l$  and  $k \neq m$ ). To produce the final good, some imported ingredients are used. Therefore, exchange rate changes have, depending on the degree of exchange rate pass-through, a direct, area wide effect on goods prices. Another important source of changes in  $Q^T$  result from changes in the price of oil which have a direct impact on the production costs for the good.

The parameter  $\gamma$  is the share of the nontraded service in the final good's production (given a Cobb-Douglas technology). We assume this parameter not to be region specific. The role of monetary policy for the development of prices stems from the fact that any increase in the money supply will lead to a equi-proportional increase in both input factor prices.

Taking logs of equation (2) and computing first differences, yields an inflation equation in period  $t$ :

$$\Delta p_{ijt} = \Delta \tau_{jt} + \Delta \ln \beta_{ijt} + \Delta \ln \alpha_{ijt} + \gamma \Delta q_{ijt}^{NT} + (1 - \gamma) \Delta q_{ijt}^T, \quad (3)$$

where small letters for  $P$  and  $Q$  indicate the log of the variable. From this equation and the comments made above it is clear that we can think of some common factors underlying regional inflation dynamics, namely the common monetary policy within the euro area (and similar monetary policies across countries in the convergence to the euro), and common external developments such as oil prices and the exchange rate. These few factors, denoted by  $f_t$  in equation (4) below, should explain a large part of the variation in regional inflation. However, there should also be a national component of regional inflation, related for example to remaining labour and goods markets heterogeneity within the euro area members and national tax policies. This national component should be captured by the national factors,  $g_{jt}$  in equation (4) below. The remaining unexplained component,  $e_{ijt}$ , is related to pure regional variables, such as local labour market conditions, which could matter even more than their national counterparts due to the low labour mobility across European regions. Structural regional differences such as factor endowments or population differences should also help in explaining the variation in regional inflation rates. We do not take that into account, however, since we analyze standardized data where a region specific mean is subtracted from each variable prior to fitting the factor model.

The discussion above provides the economic rationale of the econometric framework that we employ, i.e. a factor model and a variable based regression approach.

In the factor specification we define  $x_{ijt}$  as the (standardized) inflation rate in region  $i$  of

country  $j$  at period  $t$

$$\begin{aligned} x_{ijt} &= \lambda_{ij}f_t + \eta_{ij}g_{jt} + e_{ijt}, \\ i &= 1, \dots, N_j, \quad j = 1, \dots, 6 \quad t = 1, \dots, T, \end{aligned} \tag{4}$$

where  $f_t$  are the area wide common factors with associated loadings  $\lambda_{ij}$ , that can differ across regions,  $g_{jt}$  are the national common factors with associated loadings  $\eta_{ij}$  (also allowed to differ across regions), and  $e_{ijt}$  is an idiosyncratic region specific component.  $N_j$  is the number of regions for country  $j$ . A similar framework was used by Forni & Reichlin (2001) to analyse regional output fluctuations.

To identify the model, the area wide and the national factors are assumed to be orthonormal<sup>6</sup> and orthogonal with the idiosyncratic components, while precise technical conditions on the permitted temporal and longitudinal correlation in the idiosyncratic components are given in Stock & Watson (2002a, 2002b). Notice that the component  $\lambda_{ij}f_t$  could be also written as  $\lambda_{ij}PP^{-1}f_t$  where  $P$  is a full rank matrix whose dimension is equal to the number of factors. Under our assumption of orthonormal factors, it must be  $P = I$ . However, other more structural identification schemes could be possible, and in this sense our estimated factors are not ‘structurally’ identified. We will comment on some consequences of this feature for the interpretation of the empirical results later on.

Notice that the specification in (4) nests dynamic models where the factors can have a delayed impact on regional inflation. For example, denoting the area wide common factors by  $q_t$  and their lags by  $q_{t-1}$ , the model

$$x_{ijt} = \alpha_{ij}q_t + \beta_{ij}q_{t-1} + \eta_{ij}g_{jt} + e_{ijt}, \tag{5}$$

is equivalent to

$$\begin{aligned} x_{ijt} &= \lambda_{ij}f_t + \eta_{ij}g_{jt} + e_{ijt}, \\ f_t &= \begin{pmatrix} q_t \\ q_{t-1} \end{pmatrix}, \quad \lambda_{ij} = \begin{pmatrix} \alpha_{ij} & \beta_{ij} \end{pmatrix}. \end{aligned} \tag{6}$$

As another example of a dynamic model, let us consider the ADL(1,1) specification where each regional inflation series depends on its own lag, the factors, and one lag of each factor, namely

$$x_{ijt} = \lambda_{ij}f_t + \eta_{ij}g_{jt} + \alpha_{ij}f_{t-1} + \beta_{ij}g_{t-1} + \rho_{ij}x_{ijt-1} + u_{ijt}. \tag{7}$$

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<sup>6</sup>Note that the normality assumption is not needed for the estimation of the factors, but for inference on the loadings with finite time and cross-sectional dimensions.

Under the (so-called COMFAC) restrictions on the parameters,  $\alpha_{ij} + \rho_{ij}\lambda_{ij} = 0$  and  $\beta_{ij} + \rho_{ij}\eta_{ij} = 0$ , the model can be written as

$$\begin{aligned}x_{ijt} &= \lambda_{ij}f_t + \eta_{ij}g_{jt} + e_{ijt}, \\e_{ijt} &= \rho_{ij}e_{ijt-1} + u_{ijt}, \\u_{ijt} &= i.i.d.(0, \sigma_{ij}^2).\end{aligned}\tag{8}$$

The model (8) is again of the type (4), but with temporally correlated idiosyncratic errors.

In the Appendix we present an alternative, variable based regression approach for modelling regional inflation dynamics, related to the global VAR model by Peseran et al. (2004). We also present some empirical results, indicating that a factor model such as (8) provides a better representation of our data set.

## 4 The area wide and national components of regional inflation

### 4.1 How much comovement?

The starting point of our empirical analysis is the estimation of the area wide and national common factors,  $f_t$  and  $g_{jt}$ , respectively, in equation (4) or (8). Stock & Watson (2002a) proved that, under mild regularity conditions that also allow for temporal correlation in the idiosyncratic errors, the factors can be consistently estimated by principal components of the variables. Therefore, to estimate the area wide factors, we extract the principal components from the pooled regional dataset, which contains a total of 70 time series.

The statistical information criteria for the selection of the number of factors proposed by Bai & Ng (2002) suggest that one factor is sufficient. However, these criteria can produce unreliable results in empirical applications. Under these conditions, the information criteria tend to indicate either just one or the maximum pre-specified number of factors. Therefore we consider alternative, less formal, methods for the selection of the number of factors. Furthermore, we carry out a sensitivity analysis on how a change in the number of factors chosen at each level of disaggregation will affect the results.

The first panel of Table 5 reports the eigenvalues of the variance covariance matrix of the variables in decreasing order, the proportion of variance explained by each component, and the cumulated explained variance for up to six principal components. These figures are useful to select the number of common factors. The first factor explains about 48% of the variance in all regional inflation rates, whereas about 75% of the variance of all series is explained by

three factors.

To decide on the number of area wide factors to be used in our analysis, we notice that there is a substantial drop of about 50% between the variance explained by the third and the fourth factor, 0.106 and 0.054, respectively. Furthermore, the second and third factors are significant in the models for all regions. Also, from an economic point of view we would expect at least three different common shocks, related to demand shocks (common monetary policy), supply shocks (e.g. oil prices) and external developments. Therefore, we assume that there are three area wide factors, and estimate them by the first three principal components of the regional variables.

When the factors are regressed on area wide variables such as the short-term interest rate, M3 growth, the exchange rate and the growth in oil prices, these variables have, as expected, a good explanatory power. However, due to the mentioned lack of structural identification it is not possible to associate each factor with specific area wide macroeconomic variables. Additional insight into the economic interpretation of the factors could be provided by a structural factor approach along the lines of Forni, Giannone, Lippi & Reichlin (2005). However, our data set is not rich enough for such an approach to be implemented, since most real variables are not available on a monthly basis on the regional level.

Figure 3 compares the weights of each regional inflation rate in each of the three principal components (three upper bar plots) with the economic weight of the respective region used to compare the area wide HICP (fourth bar plot). The figure shows that there are large differences between these two type of weights. This is to be expected since the principal component analysis maximizes the explained variance rather than representing the relative economic importance of a region. Thus, Spanish regional inflation series for example obtain a relatively large weight in the first principal component, whereas German regional inflation series obtain a relatively low weight. Nevertheless, as Table 10 shows, there is a very high correlation particularly between the first factor and the euro area HICP inflation rate (0.90). Furthermore, as we will see below, the euro-area HICP inflation rate is nevertheless not a good substitute for the area wide factors for explaining regional inflation dynamics. We will also discuss in the next sections how the relative importance of the area wide, national and regional components differ geographically.

## **4.2 Explaining regional inflation with area wide and national factors**

After having obtained the area wide factors, we now discuss estimation of the national factors, and evaluate how strong the joint explanatory power of area wide and national factors is for

each regional inflation series.

For each country, we clean the regional series from the common area wide effects by regressing them on the three estimated area wide factors. The principal components of the resulting residuals can be used to estimate the national factors. This procedure is justified by the assumed orthogonality of the area wide, national and regional components.

The principal component analysis of the resulting residuals is reported in the other panels of Table 5 for Austria, Germany, Spain, Finland, Italy and Portugal. A limited number of national factors seems capable of summarizing efficiently the information in the national residual inflation series. In general three factors are again sufficient to explain about 75% of the variance of the series, with higher values for the smaller countries due to their lower number of regions. For Germany the fourth factor might be significant and for Italy the choice is not clear-cut, but for the sake of comparability we assume that there are three national common factors in each country. Furthermore, from an economic perspective we would expect at least three factors to be relevant, reflecting the role of labour market institutions, fiscal policy measures and institutional structures, including product market regulations and financial regulations. The remaining idiosyncratic regional component is rather small, i.e. up to 10% of regional inflation variance.

To consider in more details the issue of the number of area wide and country specific factors, we now evaluate whether the second and third factors are statistically significant in the model equations or whether instead they are not significant and can be excluded to yield a more parsimonious specification. We start by estimating the ADL(1,1) model in (7), namely

$$x_{ijt} = \lambda_{ij}f_t + \eta_{ij}g_{jt} + \alpha_{ij}f_{t-1} + \beta_{ij}g_{t-1} + \rho_{ij}x_{ijt-1} + u_{ijt}. \quad (9)$$

We then test the (so-called COMFAC) restrictions on the parameters,  $\alpha_{ij} + \rho_{ij}\lambda_{ij} = 0$  and  $\beta_{ij} + \rho_{ij}\eta_{ij} = 0$ , which imply that the model can be written as (8), i.e.,

$$\begin{aligned} x_{ijt} &= \lambda_{ij}f_t + \eta_{ij}g_{jt} + e_{ijt}, \\ e_{ijt} &= \rho_{ij}e_{ijt-1} + u_{ijt}, \\ u_{ijt} &= i.i.d.(0, \sigma_{ij}^2). \end{aligned} \quad (10)$$

In most cases the restrictions are not rejected, so that (8) represents our specification of the regional inflation dynamics. Notice that in this specification the parameter  $\rho_{ij}$  provides a measure of the persistence of inflation (conditional on the variables and factors), since it is equal to the coefficient of lagged inflation in the ADL(1,1) formulation of the model. The fact that estimated rather than true factors are used in (8), e.g.  $\hat{f}_t$  rather than  $f_t$ , in

general creates no generated regressor problems due to the fast convergence rate of the factor estimator when the cross-section is large, see Bai (2003).

In Table 6 we report parameter estimates for model (8). The loadings (and standard errors) of the three area wide common factors are presented in the columns labeled PCi\_ALL, those of the national factors in PCi\_CS,  $i=1,2,3$ , and the estimated persistence of inflation,  $\hat{\rho}_{ij}$ , in the column AR(1). We also report the adjusted  $R^2$  of each regional regression, and the p-values of tests for no correlation (LM), homoskedasticity (White) and normality (JB) of the residuals  $u_{ijt}$ .

A few remarks are in order. First, both the area wide and the national factors are strongly significant in virtually all regions. This confirms the remaining importance of the national components of inflation dynamics. Second, the second and third factors are statistically significant in most equations, which indicates that a model with just one area wide and country specific factors would be misspecified due to the omission of relevant regressors. Third, there is a large variability in inflation persistence, for example the range for Germany is 0.51 to 0.92. Fourth, the explanatory power of the model is quite good, with an average value of the adjusted  $R^2$  of 0.964. This is not surprising given the previous findings on the high explanatory power of a few principal components. Finally, the p-values of the tests on the residuals are in general above the standard value of 0.05, rejection of one of the null hypotheses under consideration happens in less than 15% of the regions. This provides substantial support in favour of the model (8) as a congruent representation for regional inflation series.

### 4.3 Geographical differences and their economic interpretation

Another interesting issue that can be analysed within the representation (8) is whether the area wide factors have the same effects across all regions, namely whether  $\lambda_{ij} = \lambda$ . Despite the fact that the factors are not separately identified, if the restriction  $\lambda_{ij} = \lambda$  holds for  $f_t$  it can be shown that it will also hold for any rotation of the factors  $Pf_t$  where P is a full rank matrix.

The p-value for testing the hypothesis of equality of the loading across the 70 regions is very low for all factors (Table 6). Therefore, the hypothesis of homogeneity is rejected. From an economic point of view this is an important finding, since it implies that the deviation of regional inflation from a common average value can partly be attributed to developments that affect the euro area as a whole. As mentioned in the introduction, this result is very likely due to asymmetries in the economic structure of the regions.

Figure 4 displays how the relative importance of the area wide, national and regional components differ geographically. Technically we present how the proportion of the total



regional inflation variance explained by area wide components differs across euro area regions. White and light gray indicate a small European component while dark gray indicates a large European component. The figure exhibits a lot of heterogeneity in the effect of the euro area component within nations except in Spain and Portugal (see Forni & Reichlin (2001) for similar findings for output growth). In particular in Spain the euro area wide component is quite large in all regions.

In Figure 5 we plot the proportion of the overall inflation variance explained by the respective national factors. Again, lighter areas indicate a relatively smaller proportion of variance explained by the national factors. One can see that the lighter areas correspond roughly to the dark areas of Figure 4, i.e. a region with larger area wide component of inflation will have a smaller national component. Overall, the two figures show that there are large differences between regions in the proportion of overall variance explained either by the area wide or national factors.

To obtain some intuition for potential causes of the observed differences in the relative importance of the area wide and national factors we follow Kose, Otrok and Whiteman (2003) and relate the observed differences across regions to structural characteristics of the respective economies. More specifically, to characterize the relationship between the structural characteristics of economies and the relative importance of the area wide factors, we regress the fraction of variance of each regions inflation attributable to the area wide factors a set of five explanatory variables that are related to regional characteristics. The regression results reported in Table 7 are mainly suggestive in nature because of lack of structural identification of the factors.

In Table 7 the columns labelled ‘3 Factors’ report results when three area wide factors and three national factors are used, the columns labelled ‘1 Factor’ report analogous results when only one area wide and one national factor is used (see section 5.1 for more details on these results). The five explanatory variables are the share of agricultural production in overall production (Agriculture), the market density (Market density), GDP growth (Output growth), the standard deviation of output growth (Output growth volatility) and the size of the respective region (Size).<sup>7</sup>

All coefficients have the sign expected from an economic point of view and most of them are either significant or almost significant at a 10% significance level. The size of the agricultural sector can be seen as a proxy for the state of the economic development of a region. The larger its value the less developed the region. The relative size of the agricultural sector varies from 0.2% for Berlin or Madrid to about 16% for the Algarve in Portugal. The regres-

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<sup>7</sup>The footnotes to Table 7 contain a more detailed description of how the individual variables are constructed.

sion results show that in more rural areas the area wide factors play a relatively smaller role in explaining the inflation variance in this area. The variable market density has a positive coefficient, indicating that the higher the number of business units in a region and therefore the higher competition, the more important the effect of the common euro area factor. Furthermore, higher growth in a particular region implies less importance of the area wide factor. Given that higher output growth of European regions reflects catch-up effects, this is in line with our small model presented in Section 3. The coefficient on the volatility of output growth is negative, indicating that in more volatile economies in terms of output growth the area wide factor is more important in explaining inflation fluctuations.<sup>8</sup> Concerning the impact of a region's size we find a positive correlation between the size of the region and the common component. Our interpretation of this finding is that in larger regions prices change more in line with the common euro area component because larger regions are more diversified in terms of consumer taste than smaller regions.

## 5 Additional aspects of regional inflation dynamics

In this section we analyse the robustness of the results presented in the previous section in comparison to the model with one area wide and one national factor. We also evaluate some additional aspects of regional inflation dynamics. In most cases, we only present and discuss a summary of the results. Detailed tables are available from the authors upon request.

### 5.1 Results for one area wide and one national factor

In section 4.2 we argued that a regression with three area wide and three national factors (with the exception of Finland with only one national factor) provides a well-specified model for European regional inflation rates. The finding that all 3 area wide and national factors are significant in regional inflation equations indicates an omitted variable problem if only one area wide and one national factor are included. Nevertheless, to investigate the robustness of our results with respect to the number of area wide and national factors used, we redo the above analysis using only one area wide and one national factor. As already noted in Section 4.1 the first factor explains about 48% of the variance in all regional inflation rates (see Table 5). After having obtained the area wide factor, we clean the regional series from this common area wide component by regressing them on the first estimated area wide factor. The principal components of the resulting residuals for each country are then used to estimate the national factors. The first national factor explains between 29% of the remaining regional

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<sup>8</sup>A similar effect has been found by Kose et al. (2003) for the importance of the global factor for national output volatility.

inflation variance in Germany and 50% in Austria, whereas in Finland it explains 90% of the regional inflation variance. Therefore, for the one area wide - one national factor model the idiosyncratic regional inflation component represents between 15% and 25% of regional inflation variance in all countries except Finland where it is 45%.

When we regress regional inflation series on the area wide and the respective national factor we again find that the effects of the area wide factors and the national factors differ across regions. In Figures 6 and 7 we plot the geographical distribution of variance ratios between the European-wide and national component and the total inflation variance. Again, white and light gray indicate a small European component while dark gray indicates a large European component. The figures confirm our major result from the previous section, namely that there are strong differences between regions with respect to the proportion of overall variance that is explained either by the area wide or national factors and that heterogeneity is - with the exception of Spain and Portugal - mostly found within and not between nations.

Figures 8 and 9 compare the proportions of overall inflation variance explained by the area wide factor(s) and the national factor(s) when either one or three factors are used respectively. With the exception of German regions and a number of Italian and Finish regions the plots for the area wide factors show that the first area wide factor explains the regional inflation variance to a similar extent. In line with the differences for the effect of the area wide component the effect of the national component is higher for the model with one area wide and one national factor in German, Finish and some Italian regions.

When relating the share of variance explained by the area wide factor to structural economic characteristics of the individual regions we also confirm the results obtained for the case of three factors. As columns 3 and 4 of Table 7 show, all coefficients are similar in size to the results for 3 area wide factors and have the same sign. Also in terms of significance of the coefficients our previous results are broadly confirmed.

## 5.2 The role of area wide inflation for regional inflation dynamics

The first issue we evaluate is the role of area wide inflation for explaining regional inflation dynamics. We have seen that the area wide factors are statistically significant and yield congruent statistical models. We also show in section 4 that the area wide factors have very different weights on the regional inflation rates than the economic weights, and in that sense the factors are not good proxies for area wide inflation. Nevertheless we analyse the regional inflation regression with area wide inflation instead of including the factors.

To investigate whether this is the case, we consider the model

$$\begin{aligned}x_{ijt} &= \gamma_{ij}\pi_t + \eta_{ij}g_{jt} + e_{ijt}, \\e_{ijt} &= \rho_{ij}e_{ijt-1} + u_{ijt}, \\u_{ijt} &= i.i.d.N(0, \sigma_{ij}^2),\end{aligned}\tag{11}$$

where  $\pi_t$  is the area wide inflation rate. Estimating this model,  $\gamma_{ij}$  is always statistically different from zero and the estimated values are close to one. However, when the area wide factors are added as regressors, area wide inflation loses its significance.

Notwithstanding the previous result, it can be interesting to analyze the deviations of regional inflation from the common area wide level as a function of national factors, for example to evaluate convergence issues. This is equivalent to estimating the model (11) imposing the restriction  $\gamma_{ij} = 1$ .

Overall, there are no major signs of misspecification of the estimated equations, and the national factors are strongly significant in explaining deviations of regional inflation from the area wide level. However, the average fit of the model decreases with respect to the model in (8), from 0.964 to 0.858, and, more importantly, there is an increase of about 25% in the average estimated persistence of inflation, from 0.76 to 0.94. This provides a serious warning for analyses of inflation convergence: it is better to regress regional inflation on several area wide factors rather than just taking it in deviations from area wide inflation. Otherwise, there can be a substantial spurious increase in persistence.

### 5.3 An analysis of changes in inflation

The analysis presented so far has been based on the level of inflation. If inflation would actually be integrated of order one, we might find a lower number of factors to be important when analyzing the level of regional inflation, since stationary factors would be more difficult to detect (see (Bai & Ng, 2004)). Therefore, we now consider changes in inflation to investigate the sensitivity of our results toward the stationarity assumption for inflation.

Overall, the results emerging from the principal component analysis for the regional inflation changes, for the euro area and for each of the six countries do not change with respect to Table 5. With three area wide factors we can still explain a substantial fraction of the variability of all series, 0.469, though smaller than for inflation levels (0.754), and even higher figures are obtained for the three national factors, with the exception of Italy (0.318) and Spain (0.417). For the sake of comparability, we will continue the exercise assuming the existence of three area wide and national factors also for the changes in inflation.

When the changes in regional inflation are regressed on the new set of factors, a few

interesting findings emerge. First, in general all factors are strongly significant. Second, their explanatory power is quite good, the average adjusted  $R^2$  is 0.748 (it was 0.964 for the levels), and their relative role with respect to the persistence in the series increases. Third, the average persistence parameter is -0.10 (versus 0.76 for the levels). Since this parameter is equal to  $\rho - 1$ , the fact that the average persistence is negative provides some evidence for overdifferencing the regional inflation series. This is a further justification for our choice of conducting the analysis in terms of the level of inflation. Finally, the models remain statistically well specified on the basis of the outcome of the diagnostic tests on the residuals.

On the basis of these results, which are neither qualitatively nor substantially different from those in Section 4, we will continue our investigation of regional inflation dynamics using inflation in levels.

## 5.4 The effects of EMU

The introduction of the euro in 1999 and the associated delegation of monetary policy to the ECB represent major institutional changes that can have a large impact on inflation dynamics. In particular, we would expect a larger area wide component for inflation and a decline in dispersion in the long run. However, since the formation of a European Monetary Union was to some extent expected since the early '90s, the convergence process has been a continuous, slowly evolving process such that there could be no major changes in regional inflation dynamics after the formal introduction of the euro.

A nice feature of the estimation procedure we adopt for the factor model is that it requires a large longitudinal dimension more than a large temporal dimension. Therefore, we can split our already short sample into two subsamples, and evaluate whether the figures before and after 1999 differ. In particular, we consider the samples 1996-1998, 1999-2004, and we also look at 1992-1994 for a subset of the regions (due to data availability) in order to have a benchmark for the more recent periods.<sup>9</sup>

As discussed in Section 2, there is an increase in the mean inflation rate and no major change in dispersion of regional inflation after the introduction of the euro in 1999. However, there is a marked decline in regional inflation dispersion in comparison with the period 1992-1994, where it is 1.45 compared to 0.61 in 1996-1998 and 0.70 in 1999-2004 (see Table 3).

An interesting feature of the principal component analysis for the euro area is that the fraction of variance explained by the first three factors decreases in 1999-2004 in comparison with 1996-1998, from 0.896 to 0.799. Both values are higher than the full sample figure, 0.754, indicating there can indeed be some differences in the two subperiods. In particular, it

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<sup>9</sup>The subset for which inflation rate data are available from 1992 on consists of the Austrian, German, Italian, Portuguese and Spanish regions.

seems that commonality in inflation evolution slightly decreased after the convergence phase. The different values are mostly due to the contribution of the first factor in explaining the variability of all series: it was 0.687 in the run-up to the monetary union but decreased to 0.562 afterward (and it was even lower, 0.483 in the full sample).

With respect to the first subperiod, the contribution of the first factor and of the first three factors is higher for 1992-1994 than for 1999-04 likely due to the common downward trend in regional inflation rates, which decrease from an average value of 4.89% in 1992-1994 to 1.89% in 1996-1998. The contribution of the factors is highest in 1996-1998, which provides further evidence in favour of the idea that commonality in inflation was maximum in the period closer to the adoption of the euro, related to the explicit inflation criterion to be satisfied for adoption of the euro.<sup>10</sup>

Repeating the split sample analysis at the national level, the same temporal pattern of commonality as for the euro area emerges for Austria, Spain, Portugal and, even more markedly, for Italy. Instead, for Germany and Finland there are basically no changes before and after 1999. However, for Germany there are major differences in the period 1992-1994, with substantially higher commonality, as a consequence of the convergence in inflation following the reunification.

We also evaluated the role of the area wide and national split factors in explaining regional inflation rates, by running regressions similar to those in Table 6. The major feature is a higher persistence in regional inflation in 91-1994 compared to the more recent period, but in all subsamples the factors maintain their importance as regressors, the fit is always good, though not better than for the full sample, and the models remain correctly specified.

In summary, allowing for different driving forces before and after the euro can have some effects, in particular the commonality of inflation seems to have slightly decreased after 1999 after a peak in the run-up to the monetary union. However, the explanatory power of the area wide and national factors for regional inflation on average does not increase in the two subsamples. On this basis we believe that our full sample results are reliable and not affected by major structural breaks.

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<sup>10</sup>As another procedure to evaluate the extent of the differences before and after the euro, we construct full sample factors by joining the estimated subsample factors (PC\_SPLIT), and we evaluate how similar they are with respect to the full sample factors we obtained in the previous section (PC). PC1\_SPLIT and PC1 are highly correlated, -0.964, where the negative value is just due to a different normalization. Instead, the correlations between PC2\_SPLIT and PC2 and PC3\_SPLIT and PC3 are lower, 0.585 and -0.523, respectively.

## 6 Euro regions and US cities

To benchmark and compare our results with a long established common currency area, we have collected data for the US. Unfortunately price data at the state level do not seem to be available, and those for the main metropolitan areas also present several problems of availability. In the end, we have bi-monthly data for a comparable sample, 1995-2004, for eleven metropolitan areas.<sup>11</sup>

Panel 2 of Table 3 reports some descriptive statistics for the US data. Comparing these data with the analogous euro area figures the following conclusions can be drawn: First, average inflation seems to be somewhat higher (2.50% compared to 2.18%) for US regions than for euro area regions. However, also for US regions inflation rates are somewhat lower between 1996-1998 (pre-EMU period) than after 1999 (EMU-period). A big difference between the two samples exists with respect to the measured degree of inflation dispersion. For euro area regions the dispersion is about twice as large as that for US regions. This holds for both observed subperiods and suggests that the degree of segmentation across European regional markets is considerably larger than that across US regional markets. National policies are one candidate variable to explain the larger degree of heterogeneity across euro area inflation rates. However, the euro area data set also contains a much larger number of regions, which also contribute to the higher dispersion.

The principal component analysis indicates that also for the US the first three components explain a substantial proportion of variance, 80%, see the first panel of Table 8, versus 75% for the euro area (with many more regions). In particular, the first component explains 57% of the variance in regional inflation versus 48% for the euro area.

When the estimated factors are used to explain the regional inflation dynamics in the US, they are in general strongly significant, the average adjusted  $R^2$  is about 0.80, the average persistence is 0.54 (versus 0.76 for the euro area), and there are basically no signs of misspecification of the models, see Table 9.

In summary, the factor based methodology to analyse regional inflation provides good and interesting results also for the US, though the size of the data set is rather limited. With respect to the euro area, the main difference is the lower degree of persistence of inflation,

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<sup>11</sup>In particular, monthly CPI data are available for Chicago-Gary-Kenosha, New York-Northern New Jersey-Long Island, and Los Angeles-Riverside-Orange County. For Detroit-Ann Arbor-Flint, Houston-Galveston-Brazoria, Miami-Fort Lauderdale, Philadelphia-Wilmington-Atlantic City, and San Francisco-Oakland-San Jose CPI data are released in even-numbered months. For Boston-Brockton-Nashua, Cleveland-Akron, and Dallas-Fort Worth data are available in odd-numbered months. For US areas for which data are available monthly only even month data are used. Also, at the beginning of the sample, data for Philadelphia-Wilmington-Atlantic City and San Francisco-Oakland-San Jose were monthly, but switched to even month. For Dallas-Fort Worth data were released in even-numbered months at the beginning of the sample, while the reverse is true for Miami-Fort Lauderdale.

which characterizes not only the aggregate variable but also the regional series.

## 7 Aggregate inflation dynamics: Euro area and the US

So far we have evaluated the role of the estimated area wide and national factors in explaining regional inflation. Now we consider whether they can also provide useful information for aggregate inflation.

In the first panel of Table 10 we show that the euro area (HICP) inflation is strongly correlated with the first factor extracted from the regional dataset (-0.90), with lower values for the second and third ones. It should be noted that area wide HICP is not constructed by aggregating regional series and that the principal components are derived by combining the regional series on the basis of their capacity to explain the variance in regional inflation and not on the basis of GDP weights. Therefore, the high correlation of the first factor with euro area inflation is not due to an accounting identity.

We model euro area aggregate inflation by regressing it on a set of rather standard macroeconomic variables including the euro area short-term interest rate (*IS*), unemployment (*UR*) and the growth rate of oil prices (*POIL*), of euro area money supply (*M3*), of nominal effective exchange rate (*EXR*), unit labour costs (*ULC*) and industrial production (*IP*), using the restricted ADL(1,1) model formulation.<sup>12</sup> From the second panel of Table 10 only the growth rate of money, oil prices and industrial production are significant, often with the wrong sign, and the reduction in the standard error of the regression with respect to a simple AR(1) model is minor, from 0.194 to 0.169 (the adjusted  $R^2$  changes from 0.85 to 0.89). When the three area wide factors are added to the regressor set, a number of interesting results emerge. First, all the three factors are strongly significant. Second, the coefficients of the macroeconomic variables are systematically and substantially more precisely estimated. Third, the list of significant macroeconomic variables changes. It now includes the short-term interest rate, the growth rate of unit labour costs and the unemployment rate. Only the latter variable appears with the wrong sign, maybe because unemployment did not play a strong role in wage bargaining in the euro area. Fourth, the standard error of the regression decreases substantially, to 0.108, and the adjusted  $R^2$  increases to about 0.96. Fifth, there is a major decrease in inflation persistence from 0.94 to 0.57.<sup>13</sup> Finally, the diagnostic tests on the residuals (LM test for no serial correlation, White test for homoscedasticity, and Jarque-

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<sup>12</sup>This equations could be considered as a reduced form of more structural Phillips curve type equations, that we augment with monetary and international variables. We leave the investigation of Phillips curve regressions on a regional level for further research.

<sup>13</sup>Note that this result of a more moderate inflation persistence is more in line with studies carried out within the inflation persistence network of the ESCB (for a summary see Angeloni, Aucremanne, Ehrmann, Gali, Levin & Smets (2005).



Bera test for normality) suggest that there is no indication of any major mis-specification of the underlying model.

To evaluate whether the results can be affected by the possible endogeneity of the regressors, we have estimated the equation by two stage least squares, using the second lag of all regressors as instruments. There are no relevant changes in the results presented in the final row of Table 10.

Regarding the US, from the top panel of Table 11 the first area wide factor is as in the euro area strongly correlated with CPI inflation. Moreover, from the second panel of Table 11 the effects of the inclusion of the factors into the equation for aggregate inflation are also similar to those for the euro area. In particular when US inflation is regressed on macro variables only, the gains with respect to a pure AR specification are minor, while adding also the factors significantly increases the adjusted  $R^2$  from 0.68 to 0.85. In this case the main contribution comes from the first factor, and additional dynamics is needed for the model to have uncorrelated errors. An instrumental variables regression by two stage least squares (TSLS) with five lags of dependent and independent variables as instruments does not substantially change the estimation results. Finally, the value of the measure of inflation persistence is very similar to what we have found for the euro area, 0.59 vs 0.57.

In summary, the factors extracted from the regional dataset appear to be quite important also to explain aggregate inflation. Due to the lack of identification of the factors, it is unfortunately only possible to provide alternative economically plausible interpretations, and not a single explanation for their relevance for area wide inflation. They might proxy for omitted variables, or they reduce the measurement errors when variables like industrial production growth are used as proxy for the output gap, or they could truly capture the effects of regional inflation co-movements, that are not captured in aggregate information, on area wide inflation. In any case, the results of this section provide additional evidence in favour of the relevance of studying inflation at a regional disaggregate level.

## 8 Conclusions

In this paper we analyse regional inflation dynamics in the euro area using a novel disaggregate dataset. It contains CPI data at a regional level within euro area countries, on a monthly frequency, covering 2/3 of the euro area in terms economic activity.

We employ a model where regional inflation is explained by common euro area and country specific factors and a remaining idiosyncratic regional component. We also consider an alternative modelling approach, where regional inflation is explained by area wide and country specific macroeconomic variables. However, while there are no major qualitative changes in

the results, this approach is dominated by the factor based specification, in the sense that the macro variable based regressions have lower explanatory power for regional inflation than the factor models.

A number of findings regarding the role of regional inflation heterogeneity within and across countries emerge.

First, there is a substantial common area wide component in regional inflation rates, likely related to the common monetary policy in the euro area, to external developments, in particular to changes in oil prices and exchange rate movements. While the area wide factors are strongly significant and have a high explanatory power, their loadings are different across different regions, which suggests that differences in regional inflation developments are partly due to area wide phenomena. We relate the percentage of variance explained by area wide factors to regional characteristics and find important roles in particular for the size of a region's agricultural sector, the size of the region, output growth and output volatility.

Second, the national components are relevant for explaining regional inflation, with idiosyncratic regional variability playing a minor role. Overall the component of regional inflation variation that is not due to area wide and external developments is on average about 25 %. This finding is important in view of the discussion of heterogeneity of inflation developments in the euro area.

Third, our findings do not differ substantially before and after the formal introduction of the euro in 1999, even though the average level of regional inflation has changed. This indicates a limited effect of EMU on inflation dynamics from the mid 90s onwards. However, both the average level of inflation and the regional dispersion were substantially higher in the early 90s, suggesting that convergence has largely taken place before the mid 90s.

Fourth, analysing US regional inflation developments yields similar results regarding the relevance of common US factors, but inflation dispersion is substantially lower (even though the latter result could be due to the lower number of units in the US dataset).

Finally, we find that disaggregate regional inflation information, as summarised by the area wide factors, is important in explaining aggregate euro area and US inflation rates, even after conditioning on macroeconomic variables.

Therefore, monitoring regional inflation rates within euro area countries appears to provide relevant additional information for the monetary policy maker.

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## Appendix: Factor model versus regression based approach to modelling regional inflation

As an alternative modelling approach to the factor model presented in Section 3, regional inflation could be made dependent on area wide, national and regional macroeconomic variables. Let us consider for simplicity the case where regional inflation depends on area wide variables only,  $z_t$ , so that

$$x_{ijt} = \lambda_{ij}z_t + e_{ijt}. \quad (12)$$

In this model, the regional variables are linked together by the area wide variables  $z_t$ , as for example in the Global VAR models of Peseran et al. (2004) at a national level.

To analyse whether our results for regional inflation obtained with the factor based regressions are robust in comparison with those obtained in a macro variable based approach, we have estimated an extended version of the model in (12) using money, interest rates, exchange rate and oil prices as euro area macroeconomic variables to capture area wide determinants of inflation, including common monetary policy within the euro area and common external developments such as oil price and exchange rate changes. We have also added the unemployment rate, the growth rate in wages, unit labour cost and industrial production as country-specific variables, since their heterogeneous behaviour in the countries under analysis can have different effects on regional inflation. The results of the regressions on the macroeconomic variables are available from the authors upon request.

The macroeconomic variables are strongly significant. However, the values of the adjusted  $R^2$  are systematically lower than the corresponding numbers for the factor based regressions, the losses are around 10 %.

Another interesting feature which can be evaluated is whether the rejection of homogeneity of the coefficients of the area wide factors detected within the factor based approach holds also in this variable based framework.

The p-values of the test for the null hypothesis of homogeneity do not reject in this case, except for money  $M3$  and oil prices in Italy and short-term interest rates in Portugal. In particular, the impact of a short-term interest rate and area wide  $M3$  does differ significantly across regions, which is of importance from a monetary policy point of view. However, this finding appears to be due to the substantially higher estimation uncertainty of the coefficients of the macro variables compared with those of the factors.

A final important question is to evaluate whether the factors have additional explanatory power if included in the macro variable based regression.

Therefore, we have regressed regional inflation series on both the factors and the macro

variables, i.e.

$$\pi_{ijt}^{reg} = \nu_{ij} + \lambda_{ij}f_t + \eta_{ij}g_{jt} + a_{ij}z_t + b_{ij}y_{jt} + e_{ijt}, \quad (13)$$

where  $f_t$  and  $g_{jt}$  are the area wide and national factors and  $z_t$  and  $y_{jt}$  are the area wide and national variables. In the final two columns of Table 6 we report, for each region, an F-test (F-test 1) for the non-significance of, respectively, the area wide and national factors, i.e. testing  $H_0 : \lambda_{ij} = 0$  and  $\eta_{ij} = 0$ , in equation (13). Furthermore, we report an F-test for the non-significance of the area wide and national macro variables (F-test 2), i.e. testing  $H_0 : a_{ij} = 0$  and  $b_{ij} = 0$  in equation (13). The zero effect of the factors is rejected in each region at a 5% significance level, while the zero effect of the macroeconomic variables is only rejected in 25 out of 70 regions. Therefore, macro variables might be excluded from the model in many regions, but factors always have to be included.

On the basis of these results and of the previous finding on the improved goodness of fit, we conclude that the factor model provides a better representation for our regional inflation data set.

Table 1: Countries and regions included in our study

Germany (12 NUTS-I Regions)
<b>Regions:</b> Baden-Württemberg, Bayern, Berlin, Brandenburg, Hessen, Mecklenburg-Vorpommern, Niedersachsen, Nordrhein-Westfalen, Saarland, Sachsen, Sachsen-Anhalt, Thüringen
<b>Data Source:</b> Statistical offices of the individual German states
Austria (9 NUTS II Regions)
<b>Regions:</b> Burgenland, Kärnten, Niederösterreich, Oberösterreich, Salzburg, Steiermark, Tirol, Vorarlberg, Wien
<b>Data Source:</b> Statistics Austria
Finland (4 NUTS-II Regions + Uusimaa (separate CPI data collection))
<b>Regions:</b> Ita-Suomi, Etela-Suomi (Southern Finland w.o. Uusimaa), Lansi-Suomi, Pohjois-Suomi, Uusimaa
<b>Data Source:</b> Statistics Finland
Italy (19 Major Cities of NUTS-II Regions)
<b>Regions:</b> Ancona, Aosta, Bari, Bologna, Cagliari, Campobasso, Firenze, Genova, L’Aquila, Milano, Napoli, Palermo, Perugia, Potenza, Reggio Calabria, Roma, Torino, Trento, Trieste, Venezia
<b>Data Source:</b> Istituto Nazionale di Statistica (ISTAT)
Spain (18 NUTS-II Regions)
<b>Regions:</b> Andalucia, Aragon, Principado de Asturias, Baleares, Canarias, Caabria, Castilla y Leon, Castilla La Mancha, Cataluna, Ceuta y Melilla, Extremadura, Galicia, Comunidad Madrid, Cummunidad Murcia, Navarra, Pais Vasco, La Rioja, Comunidad Valenicana
<b>Data Source:</b> Instituto Nacional de Estadistica (INE)
Portugal (7 NUTS-II Regions)
<b>Regions:</b> Acores, Algarve, Altenejo, Centro, Lisbon, Madeira, Norte
<b>Data Source:</b> Instituto Nacional de Estatistica (INE)
U.S.A. (11 Metropolitan Areas)
<b>Regions:</b> Boston-Brockton-Nashua, Chicago-Gary-Kenosha, Cleveland-Akron, Dallas-Fort Worth, Detroit-Ann Arbor-Flint, Houston-Galveston-Brazoria, Los Angeles-Riverside-Orange County, Miami-Fort Lauderdale, New York-Northern New Jersey-Long Island, Philadelphia-Wilmington-Atlantic City, San Francisco-Oakland-San Jose
<b>Data Source:</b> Bureau of Labor Statistics (BLS)



Table 2: Country/Region short names

Full	Short	Full	Short	Full	Short Name
Countries					
Austria	AU	Germany	DE	Finland	FI
Italy	IT	Spain	ES	Portugal	PO
USA	US				
Regions					
Abruzzo	laqu	Etela-Suomi (w.o. Uusimaa)	tamp	Piemonte	tori
Alentejo	evor	Extremadura	bada	Pohjois-Suomi	oulu
Algarve	faro	Fruili-Venezia Guilia	trie	Principado de Asturias	ovie
Andalucia	sevi	Galicia	laco	Puglia	bari
Aragon	sara	Hessen	hess	Regiao Autonoma da Madeira	func
Baden-Württemberg	bade	Illes Balears	palm	Regiao Autonoma dos Acores	pont
Basilicata	pote	Ita-Suomi	joen	Region de Murcia	murc
Bayern	baye	Kärnten	kaer	Saarland	saar
Berlin	berl	La Rioja	logr	Sachsen	sach
Brandenburg	bran	Lansi-Suomi	kokk	Sachsen-Anhalt	saan
Burgenland	burg	Lazio	roma	Salzburg	salz
Calabria	regg	Liguria	geno	Sardegna	cagl
Campania	napo	Lisboa	lisb	Sicilia	pale
Canarias	lapa	Lombardia	mila	Steiermark	stei
Cantabria	sant	Marche	anco	Thringen	thue
Castilla Leon	vall	Mecklenburg-Vorpommern	meck	Tirol	tiro
Castilla-La Mancha	alba	Molise	camp	Toscana	fire
Cataluna	barc	Niederösterreich	nied	Trento	tren
Centro	coim	Niedersachsen	nied	Umbria	peru
Ciudad Autonoma de Ceuta y Melilla	ceut	Nordrhein-Westfalen	nord	Uusimaa	hels
Comunidad de Madrid	madr	Norte	port	Veneto	vene
Comunidad Foral de Navarra	pamp	Oberösterreich	ober	Vorarlberg	vora
Comunidad Valenciana	vale	Pais Vasco	sans	Wien	wien
Emilia-Romagna	bolo				

Table 3: Descriptive statistics for euro area and US regional inflation rates (1996(1) - 2004(10), 1996(1) - 1998(12), 1999(1) - 2004(10))

Euro Area						
	1996-2004		1996-1998		1999-2004	
	Mean	Std. Dvt.	Mean	Std. Dvt.	Mean	Std. Dvt.
All Regions	2.18	0.63	1.89	0.61	2.26	0.70
Germany	1.35	0.15	1.21	0.21	1.31	0.20
Austria	1.62	0.10	1.19	0.17	1.73	0.11
Finland	1.41	0.09	1.07	0.05	1.60	0.13
Italy	2.26	0.22	2.13	0.33	2.22	0.22
Spain	2.87	0.22	2.45	0.25	3.06	0.24
Portugal	2.85	0.15	2.41	0.28	3.09	0.12
U.S.A.						
	Mean	Std. Dvt.	Mean	Std. Dvt.	Mean	Std. Dvt.
All Regions	2.50	0.29	2.28	0.43	2.68	0.35

**Notes:**

The mean year on year CPI inflation rate (mean) is computed as the cross-sectional mean of all regional mean inflation rates (geometric mean) included in the respective sample. The computation of the standard deviation (std. dvt.) is likewise based on the cross-section of the geometric means of all regional mean inflation rates included in the respective sample.

Table 4: Unit root tests on euro area regional inflation series, 1996(1) - 2004(10)

Individual ADF tests		
	Total Number of Re- gions	Number of Rejections (5% Significance Level)
All Regions	70	17
Germany	12	8
Austria	9	0
Finland	5	0
Italy	19	8
Spain	18	1
Portugal	7	0

Panel unit root tests		
Method	Statistics	Prob.
Levin, Lin & Chu $t^*$	-8.970	0.000
Breitung t-stat	-3.898	0.000
Im, Pesaran and Shin W-stat	-11.989	0.000
ADF - Fisher Chi-square	429.578	0.000
PP - Fisher Chi-square	422.371	0.000

**Notes:**

- 1) Results are based on regressions including a constant and lagged differences up to the highest significant lag with a maximum of 12 lags.
- 2) Critical values for the single-equation ADF-tests are taken from MacKinnon (1991).
- 3) The panel unit root results that we report are based on the methods proposed by Levin, Lin & Chu (2002), Breitung (2000), Im, Pesaran & Shin (2003) and Maddala & Wu (1999).

Table 5: Euro area wide and national factors

	Comp. 1	Comp. 2	Comp. 3	Comp. 4	Comp. 5	Comp. 6
All Regions						
Eigenvalue	33.499	11.384	7.381	3.732	2.964	1.876
Variance Prop.	0.483	0.164	0.106	0.054	0.043	0.027
Cumulative Prop.	0.483	0.647	0.754	0.808	0.850	0.877
Austria						
Eigenvalue	1.343	0.513	0.238	0.195	0.163	0.128
Variance Prop.	0.501	0.192	0.089	0.073	0.061	0.048
Cumulative Prop.	0.501	0.693	0.782	0.854	0.915	0.963
Germany						
Eigenvalue	0.701	0.501	0.385	0.328	0.160	0.100
Variance Prop.	0.291	0.208	0.160	0.136	0.066	0.042
Cumulative Prop.	0.291	0.500	0.659	0.796	0.862	0.904
Spain						
Eigenvalue	1.195	0.604	0.491	0.186	0.155	0.144
Variance Prop.	0.380	0.192	0.156	0.059	0.049	0.046
Cumulative Prop.	0.380	0.572	0.728	0.787	0.836	0.882
Finland						
Eigenvalue	1.468	0.072	0.062	0.018	0.008	
Variance Prop.	0.901	0.044	0.038	0.011	0.005	
Cumulative Prop.	0.901	0.945	0.984	0.995	1.000	
Italy						
Eigenvalue	1.283	0.860	0.451	0.350	0.320	0.288
Variance Prop.	0.299	0.201	0.105	0.082	0.075	0.067
Cumulative Prop.	0.299	0.500	0.606	0.687	0.762	0.829
Portugal						
Eigenvalue	1.341	0.778	0.440	0.155	0.105	0.102
Variance Prop.	0.453	0.263	0.149	0.052	0.035	0.035
Cumulative Prop.	0.453	0.716	0.864	0.917	0.952	0.987

**Notes:**

- 1) The area wide factors ('All Regions') are estimated as the principal components extracted from a dataset with all the regions of all countries and the sample period 1996-2004.
- 2) The national factors are estimated as the principal components, extracted for each country from the residuals of a regression of regional inflation rates on area wide components over the same sample period. We report eigenvalues associated with the first 6 principal components, the proportion of variance explained by each component, and the cumulative proportion of explained variance.

Table 6: Explaining regional inflation in the euro area

Region	PC1_ALL	PC2_ALL	PC3_ALL	PC1_CS	PC2_CS	PC3_CS	AR(1)	Adj.R2	LM	White	JB	F-Test 1	F-Test 2
au_burg	-0.099	0.111	0.055	0.364	-0.933	0.157	0.920	0.994	0.268	0.222	0.216	0.000	0.835
	0.006	0.010	0.011	0.011	0.027	0.024	0.044						
au_kaer	-0.129	0.077	-0.024	0.306	-0.036	0.140	0.612	0.913	0.528	0.364	0.388	0.000	0.488
	0.012	0.023	0.027	0.038	0.078	0.087	0.083						
au_nied	-0.164	0.094	-0.019	0.188	0.282	0.613	0.828	0.960	0.105	0.625	0.604	0.000	0.074
	0.015	0.025	0.028	0.028	0.068	0.063	0.060						
au_ober	-0.145	0.107	0.038	0.290	0.097	0.125	0.820	0.965	0.006	0.099	0.989	0.000	0.067
	0.013	0.024	0.027	0.026	0.063	0.059	0.064						
au_salz	-0.130	0.089	-0.023	0.481	0.145	-0.460	0.674	0.994	0.030	0.144	0.688	0.000	0.131
	0.004	0.007	0.008	0.010	0.022	0.023	0.078						
au_stei	-0.158	-0.002	0.061	0.299	-0.135	0.248	0.586	0.872	0.801	0.213	0.005	0.000	0.481
	0.015	0.026	0.031	0.045	0.092	0.103	0.079						
au_tiro	-0.112	0.144	-0.048	0.206	0.125	0.156	0.872	0.963	0.734	0.827	0.571	0.000	0.019
	0.015	0.024	0.028	0.027	0.067	0.060	0.046						
au_vora	-0.115	0.161	-0.067	0.293	0.223	0.341	0.810	0.957	0.020	0.029	0.550	0.000	0.000
	0.014	0.025	0.029	0.029	0.070	0.066	0.062						
au_wien	-0.125	0.123	-0.049	0.304	0.064	0.193	0.712	0.961	0.022	0.921	0.748	0.000	0.001
	0.011	0.020	0.023	0.027	0.065	0.061	0.087						
Mean	-0.131	0.100	-0.009	0.303	-0.019	0.168	0.759						
Std. dev.	0.021	0.047	0.048	0.085	0.365	0.281	0.118						
Min	-0.164	-0.002	-0.067	0.188	-0.933	-0.460	0.586						
Max	-0.099	0.161	0.061	0.481	0.282	0.613	0.920						
de_bade	-0.093	0.164	0.093	-0.144	0.327	0.169	0.858	0.969	0.698	0.434	0.211	0.000	0.142
	0.013	0.022	0.027	0.054	0.044	0.047	0.051						
de_baye	-0.093	0.175	0.107	-0.614	0.163	-0.134	0.619	0.964	0.418	0.267	0.889	0.000	0.004
	0.008	0.015	0.018	0.045	0.042	0.047	0.081						
de_berl	-0.085	0.195	0.061	-0.192	0.240	0.438	0.909	0.953	0.959	0.974	0.022	0.000	0.123
	0.017	0.028	0.034	0.068	0.055	0.057	0.042						
... to be continued													

Table 6: ... continued

Region	PC1_ALL	PC2_ALL	PC3_ALL	PC1_CS	PC2_CS	PC3_CS	AR(1)	Adj.R2	LM	White	JB	F-Test 1	F-Test 2
de_bran	-0.088	0.109	0.240	-0.457	0.117	-0.422	0.856	0.970	0.008	0.605	0.037	0.000	0.001
	0.014	0.022	0.027	0.053	0.043	0.046	0.055						
de_hess	-0.041	0.229	-0.004	0.200	0.613	0.498	0.547	0.985	0.417	0.047	0.940	0.000	0.492
	0.004	0.008	0.010	0.026	0.025	0.029	0.082						
de_meck	-0.074	0.131	0.263	0.609	0.492	-0.591	0.924	0.947	0.885	0.766	0.000	0.000	0.094
	0.019	0.029	0.035	0.072	0.058	0.060	0.046						
de_nied	-0.109	0.163	0.151	0.080	0.274	0.117	0.662	0.979	0.729	0.916	0.454	0.000	0.191
	0.007	0.012	0.015	0.037	0.033	0.037	0.074						
de_nord	-0.101	0.190	0.103	-0.002	0.246	0.172	0.869	0.971	0.109	0.318	0.414	0.000	0.507
	0.014	0.022	0.027	0.053	0.043	0.046	0.059						
de_saan	-0.076	0.120	0.267	-0.283	0.140	-0.377	0.666	0.965	0.011	0.887	0.025	0.000	0.000
	0.009	0.016	0.019	0.051	0.042	0.047	0.083						
de_saar	-0.096	0.191	0.141	-0.208	0.226	0.145	0.508	0.956	0.200	0.595	0.002	0.000	0.764
	0.007	0.013	0.016	0.043	0.043	0.049	0.090						
de_sach	-0.078	0.160	0.159	0.091	0.246	-0.203	0.817	0.970	1.000	0.295	0.000	0.000	0.072
	0.012	0.020	0.025	0.050	0.042	0.045	0.056						
de_thue	-0.077	0.181	0.095	0.023	0.307	-0.166	0.906	0.968	0.416	0.628	0.000	0.000	0.143
	0.015	0.023	0.028	0.056	0.045	0.047	0.045						
Mean	-0.084	0.167	0.140	-0.075	0.283	-0.030	0.762						
Std. dev.	0.017	0.034	0.083	0.320	0.143	0.341	0.151						
Min	-0.109	0.109	-0.004	-0.614	0.117	-0.591	0.508						
Max	-0.041	0.229	0.267	0.609	0.613	0.498	0.924						
es_alba	-0.156	-0.012	-0.043	0.253	-0.169	0.019	0.650	0.990	0.191	0.891	0.603	0.000	0.009
	0.005	0.008	0.010	0.015	0.028	0.024	0.075						
es_bada	-0.135	-0.012	-0.096	0.136	-0.157	0.027	0.943	0.976	0.996	0.358	0.971	0.000	0.339
	0.013	0.019	0.022	0.027	0.061	0.038	0.034						
es_barcelona	-0.138	-0.007	-0.088	0.291	-0.050	-0.010	0.917	0.987	0.604	0.781	0.361	0.000	0.124
	0.009	0.014	0.017	0.019	0.045	0.028	0.041						

... to be continued

Table 6: ... continued

Region	PC1_ALL	PC2_ALL	PC3_ALL	PC1-CS	PC2-CS	PC3-CS	AR(1)	Adj.R2	LM	White	JB	F-Test 1	F-Test 2
es_ceut	-0.135	-0.020	-0.091	-0.056	-0.775	-0.499	0.850	0.964	0.563	0.030	0.633	0.000	0.183
	0.015	0.024	0.028	0.033	0.077	0.048	0.064						
es_laco	-0.158	-0.049	-0.084	0.284	-0.007	-0.049	0.840	0.979	0.403	0.323	0.774	0.000	0.478
	0.011	0.018	0.021	0.024	0.055	0.036	0.059						
es_lapa	-0.117	0.060	-0.050	0.014	0.444	-0.887	0.680	0.996	0.977	0.980	0.948	0.000	0.007
	0.003	0.006	0.007	0.010	0.021	0.016	0.070						
es_logr	-0.146	-0.046	-0.077	0.326	0.311	0.064	0.706	0.957	1.000	0.038	0.681	0.000	0.185
	0.011	0.020	0.023	0.032	0.065	0.051	0.077						
es_madr	-0.153	-0.017	-0.042	0.213	-0.160	-0.045	0.871	0.982	0.198	0.022	0.389	0.000	0.006
	0.011	0.018	0.020	0.024	0.053	0.034	0.049						
es_murc	-0.153	-0.032	-0.131	0.186	-0.352	-0.092	0.853	0.974	0.517	0.548	0.411	0.000	0.105
	0.012	0.021	0.024	0.027	0.061	0.040	0.055						
es_ovie	-0.148	-0.008	-0.104	0.277	-0.085	-0.056	0.769	0.965	0.230	0.005	0.002	0.000	0.233
	0.012	0.021	0.024	0.030	0.065	0.046	0.066						
es_palm	-0.157	0.001	-0.084	0.116	0.110	0.138	0.432	0.960	0.473	0.750	0.975	0.000	0.003
	0.006	0.011	0.013	0.025	0.042	0.042	0.092						
es_pamp	-0.117	0.023	-0.095	0.308	0.048	-0.022	0.839	0.967	0.171	0.036	0.124	0.000	0.116
	0.013	0.022	0.027	0.030	0.067	0.045	0.037						
es_sans	-0.149	-0.007	-0.112	0.276	0.048	0.032	0.889	0.982	0.497	0.997	0.699	0.000	0.425
	0.011	0.017	0.020	0.023	0.054	0.034	0.049						
es_sant	-0.154	-0.047	-0.075	0.289	0.094	-0.032	0.636	0.945	0.919	0.301	0.822	0.000	0.974
	0.010	0.019	0.023	0.035	0.066	0.056	0.081						
es_sara	-0.162	-0.070	-0.038	0.294	0.095	0.052	0.742	0.983	0.309	0.319	0.874	0.000	0.632
	0.008	0.014	0.016	0.021	0.044	0.032	0.054						
es_sevi	-0.159	-0.043	-0.073	0.189	-0.191	-0.008	0.799	0.990	0.548	0.181	0.649	0.000	0.006
	0.007	0.012	0.014	0.017	0.036	0.025	0.061						
es_vale	-0.159	-0.027	-0.075	0.208	-0.183	-0.012	0.752	0.988	0.991	0.286	0.349	0.000	0.198
	0.006	0.012	0.014	0.018	0.036	0.027	0.072						

... to be continued

Table 6: ... continued

Region	PC1_ALL	PC2_ALL	PC3_ALL	PC1_CS	PC2_CS	PC3_CS	AR(1)	Adj.R2	LM	White	JB	F-Test 1	F-Test 2
es_vall	-0.161 0.006	-0.021 0.011	-0.042 0.012	0.253 0.015	0.039 0.033	-0.004 0.024	0.752 0.060	0.991	0.220	0.212	0.814	0.000	0.358
Mean	-0.148	-0.019	-0.078	0.214	-0.052	-0.077	0.773						
Std. dev.	0.014	0.029	0.026	0.104	0.262	0.240	0.124						
Min	-0.162	-0.070	-0.131	-0.056	-0.775	-0.887	0.432						
Max	-0.117	0.060	-0.038	0.326	0.444	0.138	0.943						
fi_hels	-0.053 0.010	0.126 0.017	-0.108 0.019	0.347 0.028			0.906 0.037	0.983	0.014	0.090	0.733	0.000	0.000
fi_joen	-0.078 0.005	0.187 0.010	-0.104 0.011	0.451 0.020			0.635 0.079	0.986	0.081	0.454	0.372	0.000	0.318
fi_kokk	-0.082 0.007	0.184 0.012	-0.071 0.014	0.464 0.024			0.725 0.068	0.984	0.127	0.062	0.000	0.000	0.911
fi_oulu	-0.074 0.012	0.220 0.020	-0.128 0.023	0.486 0.033			0.850 0.052	0.975	0.019	0.402	0.878	0.000	0.022
fi_tamp	-0.067 0.004	0.195 0.007	-0.101 0.009	0.460 0.016			0.590 0.081	0.990				0.000	0.125
Mean	-0.071	0.182	-0.102	0.442			0.741						
Std. dev.	0.012	0.035	0.020	0.055			0.136						
Min	-0.082	0.126	-0.128	0.347			0.590						
Max	-0.053	0.220	-0.071	0.486			0.906						
it_anco	-0.072 0.014	-0.075 0.025	0.033 0.033	0.229 0.052	-0.066 0.076	0.128 0.064	0.929 0.034	0.958	1.000	0.559	0.099	0.000	0.212
it_bari	-0.084 0.013	-0.076 0.022	0.088 0.029	0.008 0.046	0.066 0.068	-0.062 0.056	0.953 0.031	0.970	0.145	0.900	0.192	0.000	0.086
it_bolo	-0.101 0.008	-0.138 0.014	0.093 0.017	0.313 0.035	0.347 0.044	0.136 0.054	0.566 0.083	0.948	0.000	0.001	0.001	0.000	0.166
it_cagl	-0.105 0.018	-0.217 0.030	0.238 0.039	0.089 0.061	0.115 0.089	0.446 0.077	0.880 0.048	0.936	1.000	0.083	0.007	0.000	0.323

... to be continued



Table 6: ... continued

Region	PC1_ALL	PC2_ALL	PC3_ALL	PC1_CS	PC2_CS	PC3_CS	AR(1)	Adj.R2	LM	White	JB	F-Test 1	F-Test 2
it_camp	-0.096	-0.133	0.223	-0.153	-0.068	-0.455	0.827	0.894	0.080	0.134	0.060	0.000	0.159
	0.022	0.037	0.045	0.078	0.104	0.098	0.065						
it_fire	-0.112	-0.124	0.069	0.382	0.004	0.065	0.573	0.937	0.019	0.237	0.680	0.000	0.058
	0.009	0.015	0.019	0.038	0.047	0.057	0.081						
it_geno	-0.097	-0.115	-0.003	0.171	-0.241	-0.020	0.859	0.971	1.000	0.501	0.674	0.000	0.235
	0.012	0.021	0.025	0.040	0.060	0.052	0.053						
it_laqu	-0.137	-0.077	0.071	0.065	-0.562	0.042	0.433	0.961	0.141	0.207	0.056	0.000	0.001
	0.006	0.011	0.013	0.028	0.033	0.044	0.091						
it_mila	-0.097	-0.161	0.083	0.174	0.079	0.057	0.937	0.977	0.361	0.165	0.258	0.000	0.611
	0.011	0.019	0.024	0.038	0.057	0.047	0.038						
it_napo	-0.091	-0.132	0.117	-0.053	-0.215	0.185	0.874	0.960	0.678	0.057	0.613	0.000	0.740
	0.014	0.024	0.032	0.050	0.069	0.062	0.053						
it_pale	-0.125	-0.189	0.042	0.049	-0.282	0.085	0.828	0.927	0.260	0.086	0.306	0.000	0.562
	0.018	0.032	0.038	0.062	0.094	0.085	0.067						
it_peru	-0.129	-0.176	0.115	0.078	0.105	0.140	0.674	0.933	0.861	0.090	0.000	0.000	0.008
	0.012	0.022	0.026	0.050	0.066	0.075	0.075						
it_pote	-0.110	-0.120	0.076	-0.062	-0.337	-0.182	0.752	0.950	0.641	0.251	0.850	0.000	0.098
	0.013	0.021	0.026	0.047	0.062	0.066	0.073						
it_regg	-0.124	-0.119	0.179	0.033	0.213	-0.535	0.589	0.946	0.480	0.302	0.040	0.000	0.407
	0.009	0.016	0.020	0.041	0.049	0.062	0.085						
it_roma	-0.122	-0.156	0.152	0.079	0.127	-0.009	0.633	0.966	0.216	0.253	0.444	0.000	0.030
	0.008	0.014	0.016	0.034	0.041	0.050	0.083						
it_tori	-0.102	-0.050	0.050	0.203	-0.014	-0.420	0.850	0.937	0.615	0.367	0.000	0.000	0.118
	0.017	0.030	0.037	0.060	0.085	0.078	0.053						
it_tren	-0.105	-0.057	-0.038	0.635	-0.345	-0.051	0.884	0.959	0.161	0.336	0.034	0.000	0.010
	0.015	0.025	0.032	0.051	0.072	0.064	0.054						
it_trie	-0.139	-0.136	0.068	0.352	0.069	-0.223	0.588	0.957	0.650	0.255	0.000	0.000	0.000
	0.008	0.014	0.018	0.035	0.044	0.052	0.081						

... to be continued

Table 6: ... continued

Region	PC1_ALL	PC2_ALL	PC3_ALL	PC1_CS	PC2_CS	PC3_CS	AR(1)	Adj.R2	LM	White	JB	F-Test 1	F-Test 2
it_vene	-0.108 0.010	-0.142 0.018	0.064 0.020	0.301 0.035	0.222 0.048	-0.046 0.048	0.756 0.074	0.972	0.464	0.010	0.241	0.000	0.425
Mean	-0.108	-0.126	0.090	0.152	-0.041	-0.038	0.757						
Std. dev.	0.018	0.044	0.070	0.187	0.233	0.240	0.154						
Min	-0.139	-0.217	-0.038	-0.153	-0.562	-0.535	0.433						
Max	-0.072	-0.050	0.238	0.635	0.347	0.446	0.953						
po_coim	-0.110 0.014	-0.058 0.023	-0.207 0.026	0.467 0.031	0.164 0.043	-0.089 0.050	0.799 0.063	0.963	0.113	0.085	0.263	0.000	0.836
po_evor	-0.094 0.011	-0.020 0.020	-0.202 0.024	0.372 0.031	0.178 0.042	0.119 0.050	0.748 0.070	0.962	0.880	0.839	0.732	0.000	0.229
po_faro	-0.089 0.010	-0.033 0.019	-0.222 0.023	0.430 0.035	0.304 0.049	-0.241 0.058	0.604 0.081	0.941	0.044	0.392	0.676	0.000	0.190
po_func	-0.068 0.005	-0.077 0.008	-0.128 0.010	0.398 0.013	-0.572 0.018	0.673 0.021	0.718 0.073	0.993	0.946	0.800	0.719	0.000	0.536
po_lisb	-0.110 0.014	-0.037 0.025	-0.164 0.030	0.293 0.034	0.278 0.047	0.008 0.054	0.807 0.062	0.956	0.010	0.793	0.015	0.000	0.375
po_pont	-0.004 0.003	-0.046 0.006	-0.205 0.007	0.311 0.010	-0.641 0.014	-0.681 0.017	0.652 0.081	0.995	0.851	0.547	0.737	0.000	0.724
po_port	-0.109 0.009	0.024 0.016	-0.163 0.019	0.347 0.025	0.175 0.034	0.145 0.041	0.714 0.080	0.974	0.974	0.818	0.982	0.000	0.320
Mean	-0.084	-0.035	-0.185	0.374	-0.016	-0.009	0.720						
Std. dev.	0.038	0.032	0.034	0.063	0.407	0.412	0.074						
Min	-0.110	-0.077	-0.222	0.293	-0.641	-0.681	0.604						
Max	-0.004	0.024	-0.128	0.467	0.304	0.673	0.807						

**Notes:**

1) The table reports the estimated coefficients and standard errors (2nd line) for regressions of regional inflation rates on area wide factors (PCi-ALL) and country-specific factors (PCi-CS), over the period 1996-2004, allowing for AR(1) errors. The next four columns report the adjusted R2 of each regression and the p-values of tests for no correlation (LM), homoskedasticity (White) and Normality (JB) of the residuals. The final two columns report, respectively, F-tests for the non-significance of the factors (F-test 1) and of the macro variables (F-test 2) in a nesting model when each series is regressed on the factors and on the macro variables, as described in the Appendix. For each country, we also report some summary statistics.

Table 7: Regression of regional inflation variance decomposition on economic structural variables

Variable	3 Factors		1 Factor	
	Coefficient	Prob.	Coefficient	Prob.
Agriculture	-0.899	0.114	-0.500	0.449
Market density	0.003	0.560	0.003	0.624
Size	0.031	0.084	0.042	0.048
Output growth	-0.373	0.111	-0.479	0.082
Output growth volatility	-5.811	0.116	-3.225	0.452
Adj.R2	0.330		0.695	

**Notes:**

1) Table 7 reports results (coefficient and p-value) from regressing the proportion of variance explained by the area-wide factors on the share of agricultural production in total production (Agriculture), the market density in the manufacturing sector (Market density), output growth between 1996 and 2003 (Output growth), output growth volatility (Output growth volatility) and the geographical size of the respective region (Size). In columns two and three (labelled ‘3 Factors’) results are presented for the case when 3 factors are used at the area wide level. In columns four and five (labelled ‘1 Factor’), results are presented for the case that only one area wide factor is used.

2) The data for the regressors are annual and are obtained from Eurostat’s Regio database. The variable ‘Agriculture’ is constructed as the ratio of a region’s agricultural sector over the region’s overall production output (‘Gross value added at basic prices’ - Agriculture, hunting, forestry and fishing’/‘Gross value added at current prices - Total branches’) on average over the sample period. The variable ‘Market density’ is the number of business units in the manufacturing sector per square kilometer (‘Number of local units - Manufacturing’/‘Area of the regions - Square kilometers’). ‘Size’ reflects the area of each region in square kilometers (‘Area of the regions - Square kilometers’). The variable ‘Output growth’ represents the percentage change of GDP per capita between 1996 and 2003 (‘Gross domestic product (GDP) at current market prices at NUTS level 2 - Purchasing Power Parities per inhabitant’). ‘Output growth volatility’ is computed as the standard deviation of the annual regional GDP growth rates over the period 1996 - 2003.

3) All regressions include national dummy variables in addition to the variables listed above. For Germany an additional dummy variable for East German regions is included.

Table 8: US area wide factors

	Comp 1	Comp 2	Comp 3	Comp 4	Comp 5	Comp 6
Eigenvalue	7.167	1.663	1.209	0.792	0.701	0.432
Variance	0.568	0.132	0.096	0.063	0.055	0.034
Prop. Cumulative	0.568	0.699	0.795	0.858	0.913	0.947
Prop.						

**Notes:**

1) The area wide factors are estimated as the principal components extracted from the inflation series for the metropolitan areas. 2) See notes to Tables 5.

Table 9: Explaining regional inflation in the US

	US_PC1	US_PC2	US_PC3	AR(1)	AdjR2	LM	White	JB
US_BOST	-0.234 0.052	-0.058 0.112	-0.062 0.114	0.621 0.144	0.705	0.167	0.015	0.010
US_CHIC	-0.279 0.030	-0.313 0.065	0.114 0.075	0.102 0.146	0.712	0.311	0.727	0.325
US_CLEV	-0.203 0.046	-0.241 0.098	0.120 0.098	0.819 0.087	0.813	0.786	0.193	0.816
US_DALL	-0.363 0.012	0.242 0.026	0.171 0.025	0.760 0.097	0.987	0.456	0.061	0.732
US_DETR	-0.165 0.042	-0.524 0.090	-0.098 0.100	0.334 0.133	0.648	0.130	0.256	0.946
US_HOUS	-0.264 0.043	-0.071 0.089	-0.267 0.098	0.426 0.135	0.713	0.061	0.058	0.641
US_LOSA	-0.186 0.037	-0.165 0.075	-0.513 0.083	0.478 0.127	0.801	0.441	0.114	0.888
US_MIAM	-0.692 0.022	0.461 0.049	0.327 0.048	0.760 0.097	0.987	0.456	0.061	0.732
US_NEWY	-0.118 0.015	0.089 0.031	-0.187 0.036	0.284 0.141	0.785	0.120	0.321	0.855
US_PHIL	-0.230 0.045	0.170 0.098	-0.727 0.104	0.649 0.121	0.780	0.016	0.147	0.140
US_SANF	-0.099 0.032	-0.473 0.067	0.293 0.068	0.725 0.100	0.902	0.873	0.680	0.584

**Notes:**

1) The table reports the estimated coefficients and standard errors (2nd line) for regressions of regional inflation rates on area wide factors (PC<sub>i</sub>L<sub>ALL</sub>), over the period 1996-2004, allowing for AR(1) errors. The next four columns report the adjusted R<sup>2</sup> of each regression and the p-values of tests for no correlation (LM), homoskedasticity (White) and Normality (JB) of the residuals.

Table 10: Explaining euro area inflation with area wide factors

Correlation Matrix: Level of Inflation												
	HICP_ euro	PC1_ ALL	PC2_ ALL	PC3_ ALL								
HICP_euro	1.000	-0.904	0.042	0.087								
PC1_ALL	-0.904	1.000	0.000	0.000								
PC2_ALL	0.042	0.000	1.000	0.000								
PC3_ALL	0.087	0.000	0.000	1.000								
Regression Results: Level of Inflation												
	C	PC1_ ALL	PC2_ ALL	PC3_ ALL	M3_ euro	IS_ euro	EXR_ euro	POIL_ euro	ULC_ euro	UR_ euro	IP_ euro	AR(1)
HICP_euro	2.261				-0.098	0.016	-0.004	0.006	0.106	0.029	-0.024	0.940
	0.496				0.034	0.101	0.008	0.002	0.100	0.021	0.012	0.044
	AdjR2	0.889	LM	0.357	White	0.442	JB	0.510				
HICP_euro	2.399	-0.074	0.043	0.038	-0.023	-0.109	-0.002	0.001	0.074	0.029	-0.012	0.574
	0.225	0.007	0.011	0.012	0.018	0.042	0.005	0.001	0.042	0.006	0.009	0.093
	AdjR2	0.955	LM	0.213	White	0.205	JB	0.066				
HICP_euro	2.281	-0.067	0.055	0.017	0.011	-0.104	-0.003	0.002	0.009	0.033	-0.025	0.506
TOLS	0.341	0.013	0.026	0.017	0.025	0.062	0.011	0.002	0.060	0.008	0.016	0.123
	AdjR2	0.951	LM	0.001	White	0.04	JB	0.29				

**Notes:**

Sample period: 1996(1) - 2004(10); Model: ADL(1,1), regressors: euro area nominal interest rate (*IR*), unemployment (*UR*) and the growth rate of oil prices (*POIL*), euro area money supply (*M3*), nominal effective exchange rate (*EXR*), unit labour costs (*ULC*) and industrial production (*IP*), possibly adding three area wide factors; Estimation method: OLS and two stage least squares (TOLS) with the second lag of dependent and independent variables as instruments; reported values are estimated parameters (1st row) and standard errors (2nd row); p-values of tests for no correlation (LM), homoskedasticity (White) and Normality (JB) of the residuals

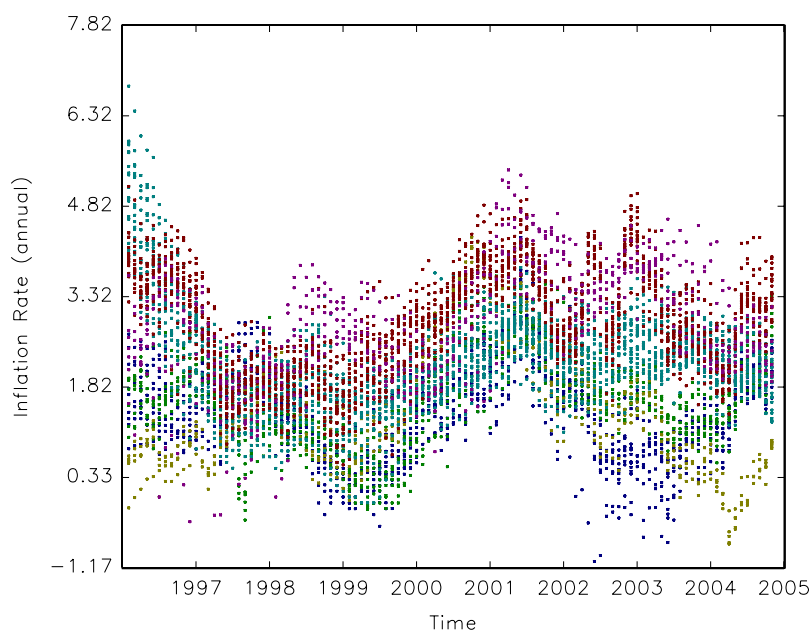
Table 11: Explaining US inflation with area wide factors

Correlation Matrix													
	US_ CPI	US_ PC1	US_ PC2	US_ PC3									
US_CPI	1.000	-0.897	-0.179	-0.082									
US_PC1	-0.897	1.000	0.000	0.000									
US_PC2	-0.179	0.000	1.000	0.000									
US_PC3	-0.082	0.000	0.000	1.000									
Explaining US inflation													
	C	US_ PC1	US_ PC2	US_ PC3	US_ M3	US_ IS	US_ EXR	US_ POIL	US_ ULC	US_ UR	US_ IP	AR(2)	AR(3)
US_CPI	0.015				0.136	0.010	-0.004	0.012	0.034	-0.010	-0.106	0.382	0.275
	0.006				0.060	0.005	0.017	0.003	0.044	0.043	0.043	0.173	0.172
	ADJR2	0.689	LM	0.239	White	0.518	JB	0.776					
US_CPI	0.016	-0.002	-0.001	-0.001	0.096	0.004	-0.020	0.003	0.014	-0.004	-0.009	0.293	0.293
	0.003	0.000	0.000	0.001	0.035	0.003	0.010	0.002	0.030	0.008	0.029	0.155	0.150
	ADJR2	0.923	LM	0.35	White	0.48	JB	0.71					
US_CPI	0.017	-0.002	-0.001	-0.001	0.081	0.004	-0.015	0.002	0.011	0.004	-0.008	0.167	0.205
(TSLS)	0.046	0.000	0.000	0.001	0.048	0.003	0.013	0.002	0.039	0.009	0.034	0.226	0.205
	ADJR2	0.923	LM	0.35	White	0.48	JB	0.71					

**Notes:**

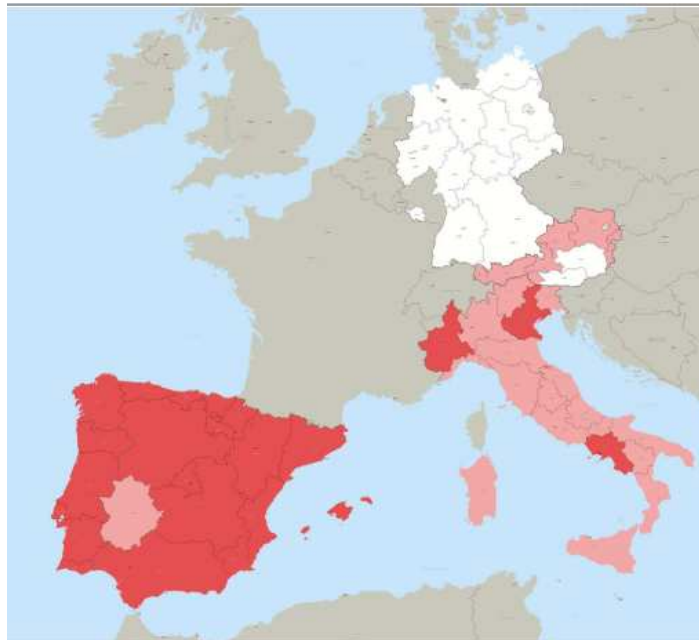
Sample period: 1996 - 2004; Model: ADL(3,3), regressors: US nominal interest rate (*IR*), unemployment (*UR*) and the growth rate of oil prices (*POIL*), money supply (*M3*), nominal effective exchange rate (*EXR*), unit labour costs (*ULC*) and industrial production (*IP*), possibly adding three area wide factors; Estimation method: OLS and two stage least squares (TSLS) with five lags of dependent and independent variables as instruments; reported values are estimated parameters (1st row) and standard errors (2nd row); p-values of tests for no correlation (LM), homoskedasticity (White) and Normality (JB) of the residuals

Figure 1: Regional European inflation rates: 1996(1) - 2004(10)



Note: *Figure 1 plots cross-sectional inflation rates for Germany, Austria, Finland, Italy, Spain, and Portugal. Inflation rates are computed as year-on-year percentage changes in the underlying consumer price index.*

Figure 2: Mean Regional European inflation rates: 1996(1) - 2004(10)



*Figure 2 plots regional mean inflation rates for Germany, Austria, Finland, Italy, Spain, and Portugal. Inflation rates are computed as year-on-year percentage changes in the underlying consumer price index. Dark regions indicate high average inflation rates. Limits for color changes are 1.5 and 2.3.*



Figure 3: Regional weights in principal components

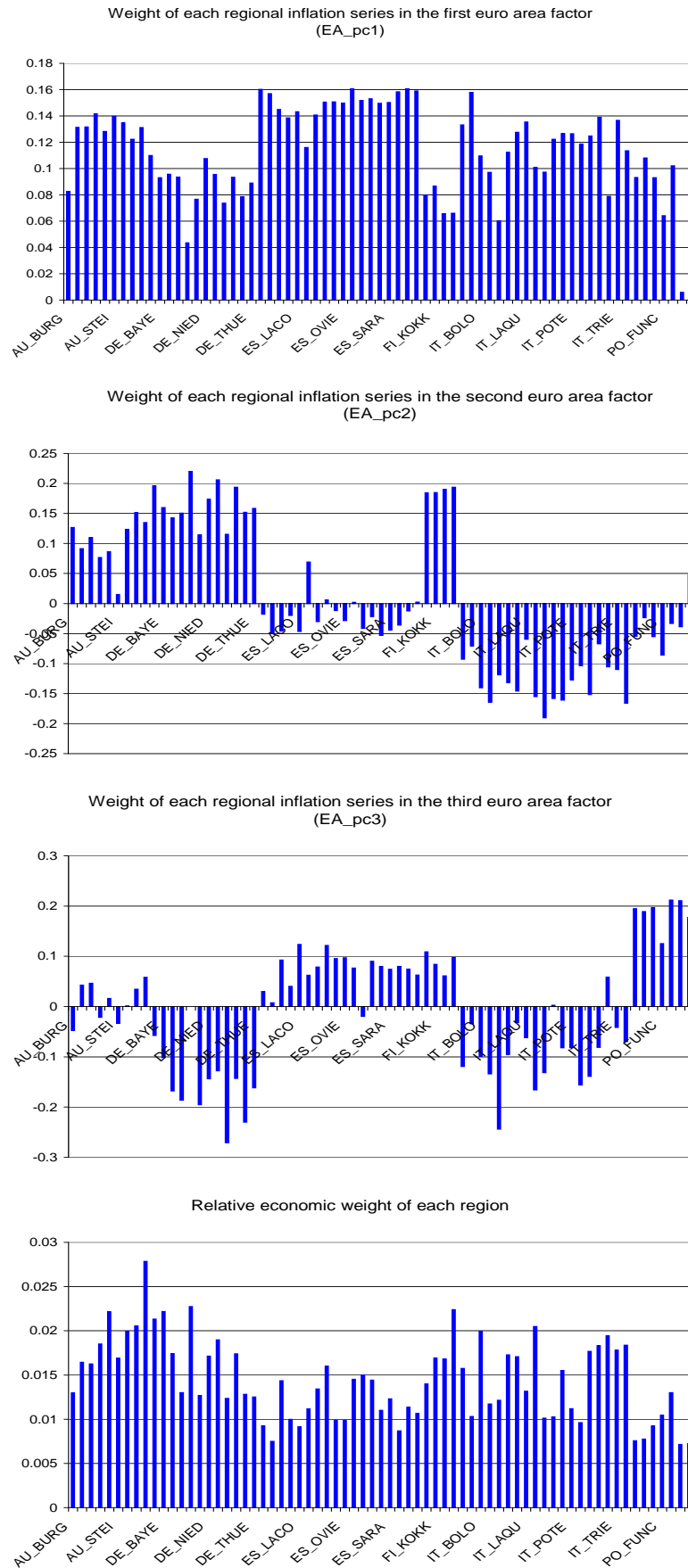


Figure 3 plots the weight of each region in the first, second and third principal component. The fourth figure plots the relative economic weight of each region.

Figure 4: Percentage of inflation variance explained by the area wide component (3 factors)

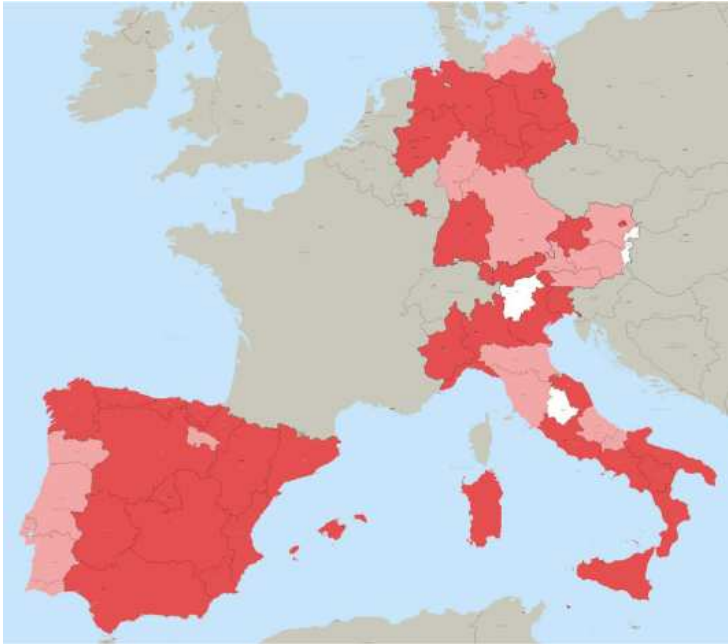


Figure 4 plots the percentage of inflation variance that is explained by three Euro area wide components. The darker a region the higher is the percentage of inflation variance that is explained by the Euro area wide components. Limits for color changes are 0.5 and 0.75.

Figure 5: Percentage of inflation variance explained by the respective national component (3 factors)

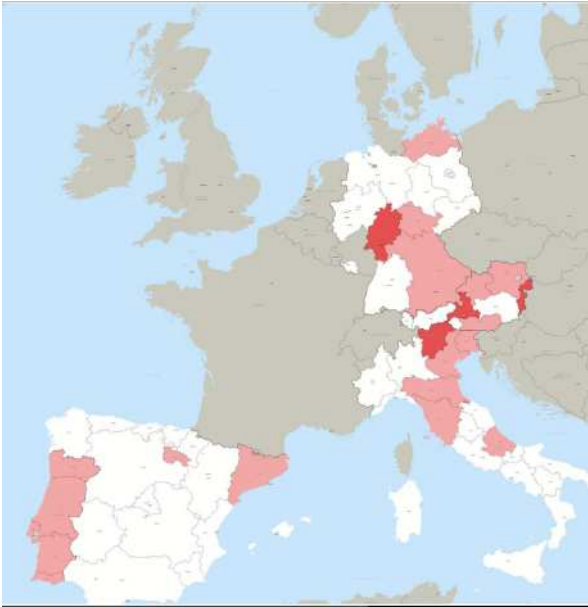
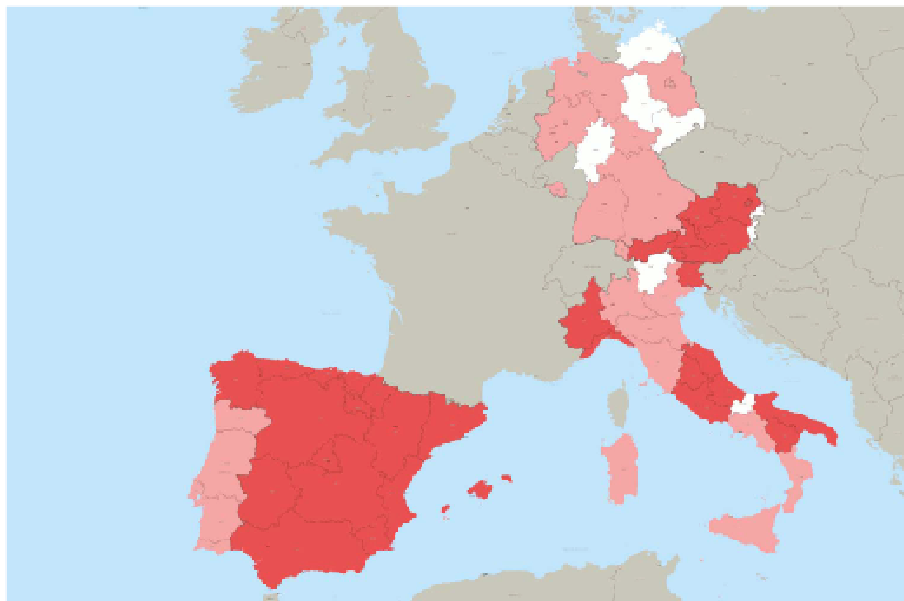


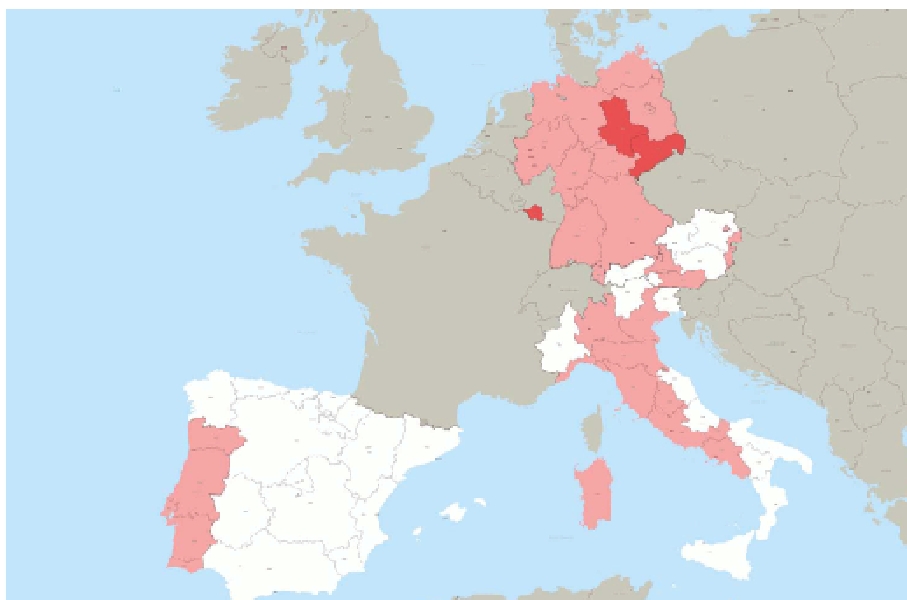
Figure 5 plots the percentage of inflation variance that is explained by the respective national components (when three national factors are chosen). The darker a region the higher is the percentage of inflation variance that is explained by the national components. Limits for color changes are 0.5 and 0.75.

Figure 6: Percentage of inflation variance explained by the area wide component (1 factor)



*Figure 6 plots the percentage of inflation variance that is explained by one Euro area wide components. The darker a region the higher is the percentage of inflation variance that is explained by the Euro area wide components. Limits for color changes are 0.25 and 0.5.*

Figure 7: Percentage of inflation variance explained by the respective national component (1 factor)



*Figure 7 plots the percentage of inflation variance that is explained by the respective national components (when only one national factor is chosen). The darker a region the higher is the percentage of inflation variance that is explained by the national components. Limits for color changes are 0.25 and 0.5.*

Figure 8: Percentage of inflation variance explained by one and three area wide factors

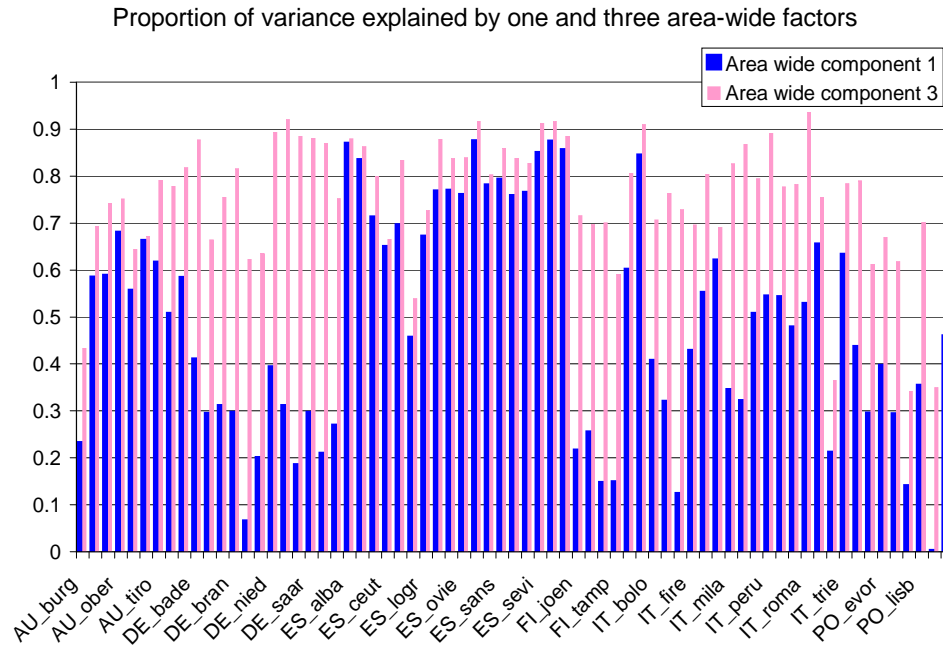


Figure 8 plots the percentage of inflation variance that is explained by one and three area wide factors.

Figure 9: Percentage of inflation variance explained by one and three national factors

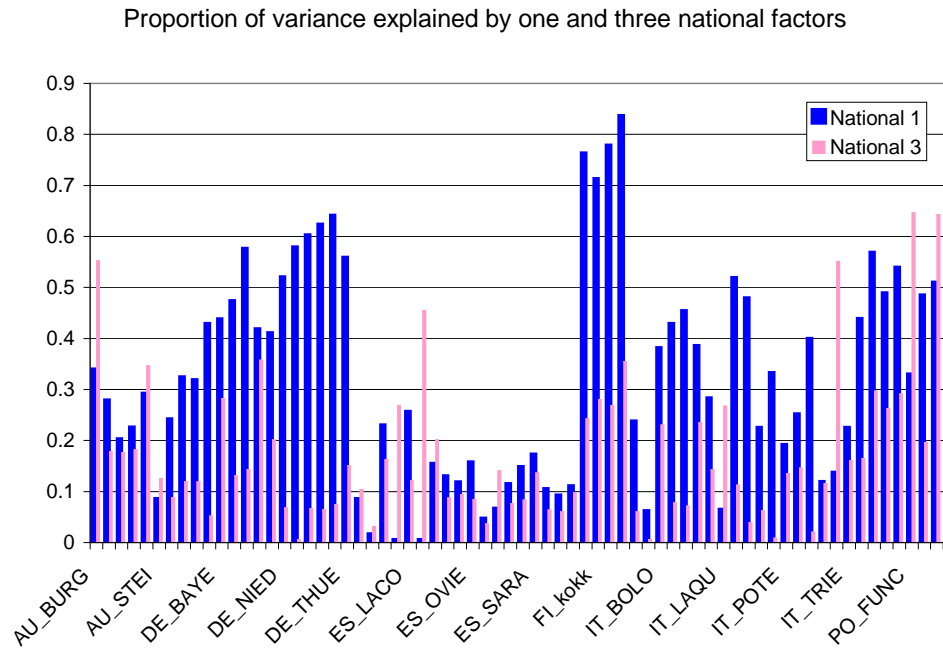


Figure 9 plots the percentage of inflation variance that is explained by one and three national factors, given one and three area wide factors respectively (Exception: Finland (only one national factor is used)).

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