

Inflation is one of the often used monetary indicators in conducting monetary policy. Even though money supply is an essential determinant of inflation, it is not used in inflation modeling. Currently, output gap is considered as most predicative variable.

This thesis brings the empirical evidence on the hypothesis of money supply carrying more information on estimating inflation than the output gap. It is provided on the case of 16 developed European economies using Bayesian Model Averaging (BMA). BMA is a comprehensive approach that deals with the model uncertainty and thus solves the variable selection problem. The results of analysis confirmed that money supply includes more information of inflation than the output gap and thus should be used in inflation modeling. These outcomes are robust towards prior selection and high correlation of some variables.