BRIEF EVALUATION ON THE PROCESS OF ACCOMPLISHING THE INFLATION CRITERION IN THE EU NEW MEMBER STATES

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Rezumat

Articolul de față prezintă succint evoluția inflației[65] în perioada august 2008 – noiembrie 2010, pentru noile state membre ale UE (NSM) şi care sunt pe lista de aşteptare în privința adoptării euro (în ordine aleatori
e, este vorba de: Bulgaria, Cehia, Estonia[66], Letonia, Lituania, Ungaria, Polonia şi România). Analiza procesului de îndeplinire a criteriului nominal al inflației se referă şi la câteva critici cu privire la modul de calcul al valorii de referință pentru inflație, având în vedere faptul că autoritățile europene (Comisia Europeană şi Banca Centrală Europeană) au luat în calculul acestui indicator şi valori negative.

Abstract

The paper presents briefly the evolution of inflation over the period August 2008 – November 2010 for the new member states (NMS) of the

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[65] *The analysed inflation is calculated on the basis of the harmonized index of consumer price, according to Eurostat methodology, as annual average of the past 12 months, taking into consideration the moment before the crisis started in the EU new member states (NMS), i.e. August 2008, and moments following this event: December 2008, April, August and December 2009, April, August, September, October and November 2010.*

[66] *Estonia is the only country scheduled to adopt the Euro on January 1st, 2011.*

EU, which are on the waiting list to adopt the Euro (in a random order, they are Bulgaria, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland and Romania). The analysis of the process of accomplishing the nominal criterion of inflation also refers to some criticisms regarding the way in which the reference value for inflation is calculated, because the European authorities (European Commission, and European Central Bank) also used negative values for the calculation of this indicator.

Keywords: inflation criterion, economic recession, adopting the euro, new member states

JEL classification: E02, E31, E32, F15, O52.

After the financial and economic crisis also reached the emergent countries (September 2008) the inflation rate tempered[67], in the new member states (NMS) of the European Union, being influenced by the sudden decrease of the economic activity and, subsequently, by the correction of these disequilibria and by the propagation of the shocks from the international markets of the raw materials onto the emerging economies. Thus, in 2009, the external pressure of the prices for the agricultural products, oil and other goods, decreased significantly, with the direct effect of lower prices for energy and foods, and with the indirect effect of decreased prices for the imported raw materials. The economic recession meant lower pay raises, constraints of the credit granting and lower consumption, which influenced the evolution of prices and, implicitly, the trend of inflation in these countries.

However, at the beginning of 2010, inflation increased slightly due to the action of circumstantial factors (higher prices for energy fuelled by the increasing oil price and the higher excises for tobacco). For the subsequent period, the forecasts of the international institutions show

[67] *Before 2008 the robust economic growth of the NMS has been accompanied by the build up of important macroeconomic disequilibria reflected, among other, in important increases of the inflation. For an ample analysis of the evolution of inflation before this period, see N. Pop et al. (2009).*

that inflation will remain at lower levels compared to the period previous to the crisis, due to the low domestic demand, but the risks of inflationist spikes subsist. Besides the increase of prices for energy and food on the world market, the increase of the indirect taxes (VAT) and of the administered prices in an attempt of fiscal consolidation are potential factors which generate inflationist pressure over the subsequent period.

In the countries targeting inflation, the evolution of this indicator was somehow more sinuous, with fluctuating trends, less dramatic decreases, compared to the countries targeting the exchange rate, and with quite high inflation rates, but with a general decreasing trend. Czech Republic is the exception, with a strongly adjusted inflation during the first half of the analysed period, when it reached the minimal limit of 9% (August 2009). After this minimal point, inflation started to increase slightly, being the only country which accomplished the reference limit imposed by the Maastricht Treaty. The deflation process in Romania was interrupted in April, and the highest inflation rate of all the surveyed countries was noticed in August 2010. The explanation of this trend is give both by the adjustment of the administered prices, to the increase of VAT[68], and to the recent depreciation of the leu and to the increasing food prices. A similar trend was noticed in Hungary until April 2010, the average annual inflation rate decreasing significantly after this period.

In the exchange rate targeting countries, inflation was corrected strongly during the first part of the interval, some countries (Estonia and Latvia) even having deflation. Lately, similarly to Czech Republic, the inflation increases slowly. Estonia experienced a fluctuating evolution of this indicator, with significant increases over the reference value (see Tables 1 and 2 in the Appendix).

Analysing the extent to which the NMS of the EU have accomplished the inflation criterion, we must highlight that the European authorities, in the 2010 Convergence Reports of the European Commission and of the ECB (European Commission, 2010 and ECB 2010), take into calculation

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[68] *According to NBR estimations, the increase of VAT will increase inflation by about 3 pp until the end of 2010.*

negative values of inflation too, as in Portugal and Estonia (in March[69]), arguing that the difference between the inflation rate in these countries and the average inflation in the euro zone is rather small. We must say that the average annual inflation in the euro zone also was negative in June-October 2009, according to Eurostat data, and this was probably a argument in favour of accepting negative inflation rates as being performant. On the basis of the reference value calculated by the European authorities for April 2009, the best performing countries in terms of price stability were Spain, Luxembourg and Portugal, all of them with negative inflation rates, close to zero. Under the current conditions characterized by significant common adverse shocks (the global financial and economic crisis, strong pressures to decrease the prices), the authorities consider that the negative inflation rates are a significant landmark for the evaluation of price stability in the European countries.

According to Table 1 from the Appendix, the only countries which managed to accomplish the inflation criterion were Czech Republic, starting with August 2009, and Lithuania, as of December 2009.

Estonia accomplished the inflation criterion is April 2009, being the only country which respected the 1.1% limit (reference inflation) at that period. Analysing the inflation in Estonia during the period of survey, one may notice rather wide fluctuations of this indicator, with quite large negative values in August and December, followed by positive values which exceeded the reference value by 0.5-3.1 pp. Taking into account the rules set by the Maastricht Treaty, in our opinion, it is not justified to give a positive evaluation for the acceptance of Estonia in the euro zone, at least on the grounds that this criterion has not been accomplished.

There are at least three reasons why the negative inflation should not be taken into consideration in calculating the reference value.

First, the countries which scored such values are not the most performing as regards other macroeconomic indicators (Spain and

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[69] Eurostat publication, „Harmonized Indices of Consumer Prices, August 2010" (Published inn Focus nr.39/2010), of August 2010, gives modified data for march 2010, which no longer corresponds with the convergence reports of the CE and ECB.

Portugal would be taken into consideration for the calculation of the reference value in April 2009, while Ireland, Estonia and Latvia would be considered for December 2009; in April 2010, the reference value would be negative as Ireland and Latvia had larger negative values of inflation). The negative inflation rates actually are signals of the adjustments in economy following the effects of the global financial and economic crisis.

Second, the negative reference values are, though, exceptions from the rule, and the developed countries who scored negative values close to zero[70] returned subsequently to positive values, which shows the incidence of the effects caused by the financial and economic crisis (economic recession) and of the applied measures of austerity. The sustainability of inflation presumes that the satisfactory performance of the inflation must be assigned primarily to the input costs and to other factors which influence the evolution of prices rather structurally than as effect of circumstantial factors. Hence, the examination of convergence presumes the evaluation of the factors which determine inflation and of the medium-term forecasts.

Another reason why negative values should not be taken into consideration when calculating the reference value for inflation refers to the attitude which the same authorities had versus Lithuania, in 2004. The 2004 Convergence Reports of the European Commission and of the European Central Bank, uses the expression “the most performing countries in terms of price stability” is interpreted with the meaning that those countries scored the lowest **positive** inflation rates. Based on these interpretations, in 2004, Lithuania has been the first country excluded from the calculation of the reference value, ECB claiming that the countries with negative inflation rates are not considered to be the best in terms of price stability (CE, 2004) and that the inflation in Lithuania in that year had been influenced by specific factors which cumulated during that period of evaluation. ECB authorities considered that taking that specific value into consideration, would have distorted the reference value as indicator with economic significance. ECB made no

[70] *In August 2009, negative inflation rates had also been recorded in: Belgium -0.7%, France and Luxembourg, both with -0.2%.*

rule in this matter, suggesting that it may consider, in the future, negative inflation rates, as it did now.

The negative inflations is some EU countries reflect dramatic corrections either in economies with unsustainable development (the Baltic States, Spain, Portugal), or those which had adapted to the new economic environment by the measures of austerity they adopted, under the circumstances of the dramatic economic recession (France, Germany, Luxembourg[71]).

Setting the reference value should take into consideration a wider framework of macroeconomic analysis, starting from the evaluation of those countries with lower inflation rates.

If only positive values are taken into consideration, the general picture changes and Bulgaria meets the inflation criterion for August and September 2009 (see Table 2 in Appendix). Also, according to the latest Eurostat data, Czech Republic would meet the inflation criterion (HICP, as annual average) starting from April 2009, to the present moment (November 2010), while Lithuania managed to be below the limit in December 2009. We eliminated the countries with deflation, because the negative value (as for Latvia or Ireland) is not a performance itself, rather a signal of "discouraging" the economic activity, with probably more serious consequences in time, by higher unemployment rates (decrease of the demand for goods and services) and social costs. The explanation of the negative inflation rates in the two countries consists in the significant decrease of the consumption expenditure due to the economic recession and due to the sudden decrease of the price of goods. At the same time, the consistent decline of inflation in 2009, occurred on the background of the impact of worldwide decreasing prices for foods and energy, compared to 2008.

In perspective, inflation tends to remain at low values, reflecting the adjustment in progress of the nominal wages, although the fiscal

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[71] *In August 2009 there has been a high frequency of negative inflation rates in the EU (10 countries of 27), but the highest frequency of negative inflation rates were in July 2009 (14 countries) and October 2009 (13 countries), according to the latest available Eurostat data (October 2010).*

consolidation which increases the indirect taxes will affect temporarily the annual inflation. The negative values of the inflation rate in Latvia, which persist since the second half of 2009, show that the economy doesn't revive too quickly. Despite massive corrections and despite signs of stabilization, the domestic demand is expected to keep decreasing because of the persistent payment of debts in the financial sector, of the weakened labour market and of the undergoing massive process of fiscal consolidation.

The positive inflation rates from Estonia (as of March 2010) do not reflect economic revival, rather measures of fiscal consolidation by the increase of the indirect taxes (VAT, excises) and by the increasing prices for energy and vegetal products (both imported and indigenous).

Although the evolution of inflation is on a rising trend because of the economic recession in the NMS, this indicator exceeds the reference value in most of these states, except Czech Republic and Lithuania.

The new EU member states display a balance between the factors generating price increase and those generating price decreases but, on the long-term, the determining factor for the evolution of inflation consists of the trends of the ration between wages and work productivity. The economic crisis reduced the positive lag between wages and work productivity in the new member states, but the further reduction of the gap depends on the enforcement of structural reforms and on a prudent evolution of the fiscal policy.

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APPENDIX

Table 4
Inflation criterion and the reference value calculated according to the European authorities

Countries	aug.08	dec.08	apr.09	aug.09	dec.09	apr.10	aug.10	dec.10
Bulgaria	11,8	7,2	3,8	1,3	1,6	3,0	3,2	4,4
Czech Republic	6,2	3,3	1,3	0,0	0,5	0,9	1,5	2,3
Estonia	11,1	7,5	0,9	**-0,7**	**-1,9**	2,5	2,8	5,4
Hungary	6,4	3,4	3,2	5,0	5,4	5,7	3,6	4,6
Latvia	15,6	10,4	5,9	1,5	-1,4	**-2,8**	-0,4	2,4
Lithuania	12,2	8,5	5,9	2,2	1,2	0,2	1,8	3,6
Poland	4,4	3,3	4,3	4,3	3,8	2,7	1,9	2,9
Romania	8,1	6,4	6,5	4,9	4,7	4,2	7,6	7,9
Slovakia	4,4	3,5	1,4	0,5	0,0	0,7	1,1	1,3
Slovenia	6,0	1,8	1,1	0,1	2,1	2,7	2,4	2,2
Reference value	*4,6*	*2,4*	*1,0*	*0,0*	*-0,5*	*-0,2*	*1,3*	*3,2*)*

Note: The cells filled with colour show accomplishment of the inflation criteria, while the figures in Bold show negative values
Source: Eurostat Data

Table 5
Inflation criterion and the reference value calculated according to the positive inflation

Countries	aug.08	dec.08	apr.09	aug.09	dec.09	apr.10	aug.10	dec.10
Bulgaria	11,8	7,2	3,8	1,3	1,6	3,0	3,2	4,4
Czech Republic	6,2	3,3	1,3	0,0	0,5	0,9	1,5	2,3
Estonia	11,1	7,5	0,9	**-0,7**	**-1,9**	2,5	2,8	5,4
Hungary	6,4	3,4	3,2	5,0	5,4	5,7	3,6	4,6
Latvia	15,6	10,4	5,9	1,5	-1,4	-2,8	-0,4	2,4
Lithuania	12,2	8,5	5,9	2,2	1,2	0,2	1,8	3,6
Poland	4,4	3,3	4,3	4,3	3,8	2,7	1,9	2,9
Romania	8,1	6,4	6,5	4,9	4,7	4,2	7,6	7,9
Slovakia	4,4	3,5	1,4	0,5	0,0	0,7	1,1	1,3
Slovenia	6,0	1,8	1,1	0,1	2,1	2,7	2,4	2,2
Reference value	*4,6*	*2,4*	*1,9*	*1,6*	*1,8*	*2,0*	*2,6*	*3,2* *)

Note: The cells filled with colour show accomplishment of the inflation criteria, while the figures in Bold show negative values
Source: Eurostat Data