Intervention Budapest

27-28 February 2003

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I liked this paper a lot and so did my colleagues at the OECD. Since I have the obligation anyway to offer some criticisms, let me say that the only thing I really miss in the paper is a clearer exposition of the policy implications. As it stands it seems too complacent about the challenges central European countries will face in the run up to EMU membership and afterwards.

More specifically, we should not lend credit to the notion that central European countries are already in a way protected from "excess inflation" risks. By "excess inflation" I mean over and above a level consistent with a catch-up process and the EMU-wide inflation target. And the risks apply both in the "pre-entry" sense and the "post-entry sense". However, before getting any further into substantive issues, let me tell you how this discussion will be organised. I shall start with a short presentation of the paper and its motivations, followed by some methodological comments and a policy discussion.

I) Short presentation of the paper and its motivations

The paper endeavours to shed light on a difficult question: do accession countries have a good chance of entering the EMU in the near future? At least, can they comply in terms of inflation convergence?

This is a question worth asking: Poland and the Czech Republic have recently achieved very low rates of inflation, in line with the euro average. Hungarian inflation is down to 4-5 per cent, i.e. not too far off target. However, these good results might have been achieved “à l’arrachée”, at the price of other disequilibria in the rest of the economy such as, for instance, exceedingly weak activity. Achieving and maintaining low inflation is indeed a difficult process.

In this context the motivation of the paper is the following: how difficult will it be to cope with autonomous, structural, inflationary pressures[1] in the run up to EMU membership? Knowing exchange rate policies will be more constrained and less able to allow for the sort of disinflationary appreciation of the currency so widely used in the past. It would be good altogether to avoid or at least minimise these potential tensions. It would indeed be a relief if, for instance, the sources of autonomous inflation were to abate spontaneously in the future, easing in the process the task of accession countries.

Whether autonomous inflationary pressures will abate depends in turn on their inner nature. They may reflect successive one-off shocks such as price liberalizations and tax increases or, to the contrary, more continuous phenomena such as the so-called “Balassa-Samuelson effects” (BS).

In this respect, the best of worlds would be for current inflation to reflect strong one-off effects while pressures of the continuous type would be weak. If that were true, and forecasting ahead, we could thus expect “one-off effects” to vanish, leading to a spontaneous deceleration of inflation.

To disentangle BS from one-off and other effects, the authors have provided us with a very interesting and careful accounting exercise. They find out that BS effects might have contributed from 1 to 2 per cent to overall inflation over the past decade in central Europe and they expect this contribution to decline in a context where the productivity catch-up will moderate progressively.

[1] Autonomous inflationary pressures can be defined as pressures that do not originate from excess demand situations.

In parallel, the authors provide us with a very thorough survey of empirical papers devoted to assessing the qualitative importance of BS effects, both in accession and other countries. They find that the most reliable papers tend to conclude that what the authors call non-core EU countries were experiencing BS effects of a similar – one to two per cent – magnitude before entering EMU. If it worked for Spain, Portugal and Greece, why not for central European countries?

II. Analytical/Methodological Comments

First of all, I find the "inflation" accounting exercise very useful and well-inspired:

- It is good to have a systematic comparison between central European economies;
- It is good to look at the sectoral level in a very precise way;
- It is indeed very important to break down the appreciation of the aggregate real exchange rate into the real exchange rate of traded goods, which is unrelated to the BS effect and the relative price of non-traded goods, which precisely captures the BS effect.
- The results look robust, but they are by necessity drawn from a small sample.

However, it might be dangerous to extrapolate this sort of "*ex-post*" accounting into the future:

- EU membership will be a new experience. It might speed up the productivity catch-up and therefore increase BS effects rather than the opposite. We do not know how robust the authors' assumption of a progressive decline in the productivity catch-up is. Structural changes can indeed be non-linear.
- The framework is not in a true sense an inflation accounting exercise. It is dealing with changes in relative prices such as real exchange rates (internal and external) while inflation, in the end, is a nominal phenomenon.

It is here, when we get to policy conclusions, that the paper is over-reaching. An obvious source of trend inflation left out by the paper is indeed the impact of strong capital inflows when nominal exchange rates are not fully flexible.

These capital inflow pressures may show up in both rising consumer and asset prices (housing and financial assets). We should therefore not jump from moderate BS effects in the past to strong conclusions about the likely absence of "excess inflation" in the future.

III. Today's debate is very focussed on EMU accession

This is natural but we should not forget that there is a life and a tough one once in EMU. "Balassa countries" should already incorporate this challenging perspective in their policy-thinking.

What past EMU experience shows is that it is not easy to control inflation when you enter EMU with inflation above average. The main difficulty lies in the fact that you may "benefit" from very low short-run real interest rates. Over the past few years Spain, for instance, has experienced very modest or even negative real short-run rates.

There is a kind of "inflation-multiplier" here. High inflation, nurtured for instance by Balassa effects, brings accommodating real interest rates and more inflation. The correcting mechanism comes later when real exchange rate appreciation starts depressing external demand and overall activity. In the process there is a risk for the traded sector to be crowded out with potentially adverse consequences on long-term growth. To avoid these various difficulties, there is a need in "Balassa countries" for:

- Running tight fiscal policies to contain domestic demand;

- Carrying out vigorous economic reforms to increase downward pressures on domestic prices.

In this perspective, it might be interesting to note that the euro-area has so far not performed as well as expected. After 1999 there was a resurgence of EMU-wide inflation in a context where there was not enough downward price flexibility in low growth/low inflation countries to offset upward pressures in overheating ones. As a result, and despite some divergences in inflation rates across countries, aggregate inflation remained stubbornly above 2 per cent well into the economic slowdown.

The outcome would have been much better had fiscal tightening (in overheating economies) and disinflationary economic reforms really materialised over these past few years. What applies today for EMU members will apply tomorrow for catching-up countries from central Europe. Fiscal discipline and vigorous economic reform are key to successful monetary integration.