



Issues of Convergence in Economies with a Fixed Exchange Rate – Experience of the Baltic Countries

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With entry to the euro area, our economy will face several changes. Together with the koruna also its exchange rate against the euro will cease to exist. At the same time, independent monetary policy will expire, thus the only active instrument to influence macroeconomic stability other than structural policies will be fiscal policy. How will the further convergence of our economy develop? How will this be reflected in the price development and in real appreciation?

A hint in this context could be a look at the convergence in countries having a fixed exchange rate against the euro. In a sense, exchange rate fixation to the euro entails similar conditions as the euro area accession. New member states include economies that have operated a fixed exchange rate against the euro for several years, while being in their level of convergence close to that of Slovakia. An example of such economies are the Baltic countries Estonia, Lithuania and Latvia. Moreover, fixation of Baltic currencies to the euro was preceded by fixed regimes against other currencies. Long-term experience of these countries with the fixed exchange rate regime and later on particularly with fixation to the euro points to some issues of convergence (as if) “after the euro introduction”, which can be illuminative for new countries including Slovakia.

The aim of this article is to answer the question, which warnings, risks and information result from the Baltic experience, particularly for our economy. To answer this, one has to realize several reservations. First of all, as a matter of principle, the Baltic economies are different from the economy of Slovakia. Their current situation is a specific case of accumulation of imbalances. A quite substantial challenge is to identify which of the current problems of the region simply result from the fast convergence under a fixed exchange rate (theoretically, Slovakia could face similar problems in the future) and which problems are case-specific to these economies only. We tend, to a certain extent, to infer the current situation from what these economies went through from the beginning of the 90s. In a special way, the development of the region was influenced by the chosen fixed exchange rate regime – in the early periods it had a stabilizing effect, while in recent time it has probably contributed to an intensification of some problems. Despite the reservations, the Baltic experience provides us – applying an adequate level of abstraction – with several warnings, but also positive prospects for our further convergence after euro area accession.

NON-TECHNICAL SUMMARY

The current economic situation in the Baltic countries is tied to the considerably uneven development so far. A marked price adjustment at the cost of GDP losses in the first half of the 90s probably set the stage for high growth rates and low inflation after 2000. Economies became stabilized thanks to strict fiscal measures accompanied with adoption of a fixed exchange rate regime against various currencies. The rapid real appreciation of the 90s, influenced primarily by the price component, slowed down after 2000-2002. This was caused by lower inflation differentials, but also by a gradual stabilization of NEER as a result of the exchange rate fixation to the euro.

The Baltic region successfully progresses in convergence thanks to sharp productivity increases. The current situation, however, reflects not only a favorable development of the fundamentals, but also considerable imbalances. The region has been overheated approximately since 2005, which is reflected in the acceleration of the previously low inflation. The higher inflation figures are probably determined by a number of factors, with the fixed exchange rate regime being just one of them. The issue of accelerating inflation in the region seems to be a wider problem.



1 Over the entire text, we try to include as complete data series in the charts as possible.

2 According to a de-facto classification of the IMF as of July 31, 2006.

Links to the inflation behavior can be seen in demand pressures accompanying the positive output gap, but also in the labor market and other spheres.

The Baltic economies experience a historically strong economic growth, which has been, however, lagging behind the growth of domestic demand. This is due to the negative contributions of net exports to GDP growth, resulting from high demand-driven imports, but also from decelerating exports. The external imbalance in the Baltic region increases, which is manifested not only in current account deficits, but also in the growing external indebtedness of these economies.

The strong domestic demand is fuelled both by a fast growth of real wages and by the growing debt of the private sector. Labor costs in the Baltic economies grow at a faster than adequate rate against real productivity. This is implied by the labor market imbalance with the labor force supply being short. Lack of suitable workers became particularly marked in some industries. For the most critical branch in the macroeconomic stability point of view we consider the construction industry and the associated boom in the real estate market.

Massive lending which stimulates the strong household demand and through mortgage loans also influences the real estate market has its reasons in financial deepening, as well as in low interest rates. Due to the fixed nature of the exchange rate, credit expansion is not to dampen by means of interest rate policy. Influencing the credit development is even more difficult due to the fact that a major proportion of the credit portfolio is built up from assets denominated in foreign currencies and that the banking sector is, to a large extent, in the hands of foreign players.

Macroeconomic stability in the region has been also influenced by the setting of fiscal policy. In the 90s, fiscal policy was one of the instruments for the stabilization of economies. "Traditionally", public budgeting has recorded low deficits or surpluses in the Baltic countries. Despite positively looking fiscal figures, we perceive several warnings in the current situation regarding a possible pro-cyclical impulse to the economy. Drawing money from EU funds could represent an additional effect similar to a fiscal impulse.

Some problems of the Baltic countries result directly from the fixed exchange rate regime they have operated for several years. These economies, however, also face some problems that are case-specific and are not directly related to exchange rate policy. What information can we draw from the experience of these countries? On the one hand, a look at their development provides several warnings for further convergence of Slovakia after euro area accession. Similarly to the Baltic countries, our economy will lose its floating exchange rate against the euro. The actual fixation of the koruna to the euro is likely to diminish the dampening effect on the prices of tradable goods and food. Owing to the loss of an in-

dependent monetary policy, the importance of fiscal policy, which should be all the more countercyclical, will increase. With a certain abstraction, we also can draw a lesson from the tense situation on the labor market and from the credit development.

On the other hand, the comparison of the development in the Baltic economies and the Slovak economy implies several advantages for us. Our economy has, in every respect, passed a more balanced development than the Baltic region. In addition, the euro area accession will happen at a time when the economy will be at a higher level of convergence than the Baltic countries. The fixation of the koruna exchange rate to the euro will not be used as a stabilizing instrument. On the contrary, euro area membership can help further convergence in a balanced way.

1. REAL AND PRICE CONVERGENCE

Within new EU member states the Baltic countries belong to small, relatively open economies. In terms of productivity and living standard they are catching up with the more advanced countries of the "old" EU-15. This is, on the other hand, associated with adjustments in prices and costs. It seems, however, that the convergence in the Baltic region had a quite imbalanced development. Incomplete or non-available statistical data¹ in the period before the introduction of the fixed exchange rate regime represent a certain limitation for the analysis.

The first half of the 90s in the Baltic countries was characterized by two to three digit inflation rates, decrease of which was accompanied by considerable losses on GDP. The price adjustment was reflected in real appreciation passing through inflation differentials. Strict fiscal policy together with fixation of the currencies under a currency board or fixed peg regime² helped to stabilize the price development over the second half of the 90s.

Table 1 Year-on-year growth of the GDP and of prices (%; average for the period)

		Estonia	Latvia	Lithuania	Slovakia
CPI	1991-1994	68.7	129.3	241.2	13.4
	1995-1999	14.8	11.6	15.8	7.8
	2000-2006	3.7	4.2	1.3	6.6
GDP	1991-1994	-1.6	-13.5	-13.2	6.2
	1995-1999	5.0	4.1	4.6	4.8
	2000-2006	9.1	8.5	7.2	4.6

Source: IMF (IFS).

The specific situation in the 90s probably set a starting point for the extraordinarily favorable period after 2000, characterized by a strong economic growth and low inflation rates. Economies had probably an overvalued exchange rate in the first period and were gradually returning to the equilibrium through high productivity in-



Box 1

Exchange rate policies of the Baltic countries

The exchange rate policies of the three Baltic countries rely on a nominal anchor, currently the fixed exchange rate of the respective currency against the euro. Their exchange rate regimes, however, are different (according to the IMF de-facto classification as of July 31 2006). Lithuania and Estonia use the so-called currency board arrangements³ while Latvia operates a fixed peg against the euro.

These countries have a long-term experience with the fixed exchange rate. The pegging of the Baltic currencies to the euro was preceded by the anchoring of the currencies to the German mark, SDR or the US dollar. As a part of the preparations for the euro⁴, all three currencies participate in the ERM II mechanism. The Estonian kroon and the Lithuanian litas acceded the mechanism on June 28, 2004 without changes in the unilateral commitments towards the euro. The Latvian lats has been in the ERM II since April 29, 2005 with an unchanged parity and a unilateral obligation to fluctuate $\pm 1\%$. That means that all three countries respect the standard fluctuation band and their unilateral commitments do not require any further actions of the ECB.

The differing choice of currencies to which the Baltic countries pegged their exchange rate, as well as the timing of this step have, according to some studies, somewhat influenced their price development in the past. To be more precise, prices in the region were influenced by the

development of the euro against the US dollar, i.e. the two main currencies to which the Baltic currencies were fixed⁵. While in Lithuania this has contributed to a more stable inflation, in Latvia it probably had a negative impact. In the case of Estonia, the influence is rather neutral.

The litas was initially fixed to the US dollar, thus the Lithuanian price index on the background of the US dollar appreciation remained at a low level in the period from January 1999 to early 2001. The Lithuanians have replaced the peg to US dollar by a peg to euro at a time the litas reached its strongest rate. The subsequent appreciation of the euro against the US dollar until early 2004 continued to have a favorable impact on the development of inflation.

The Latvian lats recorded an opposite development. It has been depreciating against the euro⁶ from the first quarter of 2001 together with the US dollar. The lats was fixed to the euro in December 2004, i.e. at a time when its market exchange rate was at its lowest level. It is possible that the chosen fixed parity was undervalued. The US dollar depreciation, as well as the timing of the change in the peg, are likely to have influenced Latvia's inflation upwards.

Currently, the chosen monetary policy strategy provides a rather limited space for the stabilization of inflation – for instance, these countries cannot actively use the key interest rates.

3 According to the IMF classification, a currency board arrangement is an explicit commitment to exchange a domestic currency for a certain foreign currency at a fixed exchange rate. The domestic currency can be issued only against foreign exchange reserves and must be permanently covered by foreign assets. This implies a considerably limited space for an independent monetary policy. As a comparison, the conventional fixed peg enables the exchange rate to fluctuate only $\pm 1\%$ over a minimum of 3 months, its level being maintained by interventions. Restrictions are thus somewhat smaller in the case of a fixed peg (there is for example the possibility to change the fixed exchange rate level).

4 The Baltic economies sought to introduce the euro at the earliest possible date. Lithuania and Estonia originally planned their euro area accession at the beginning of 2007. Due to risks posed to its price development Estonia has on own initiative postponed its accession date. The assessment of the European Commission and the ECB in May 2006 has not recommended cancelling the derogation for Lithuania as the reference value of the inflation criterion has been exceeded. At present, there are no concrete dates for the euro adoption in two Baltic countries, Lithuania should not adopt the euro before 2010.

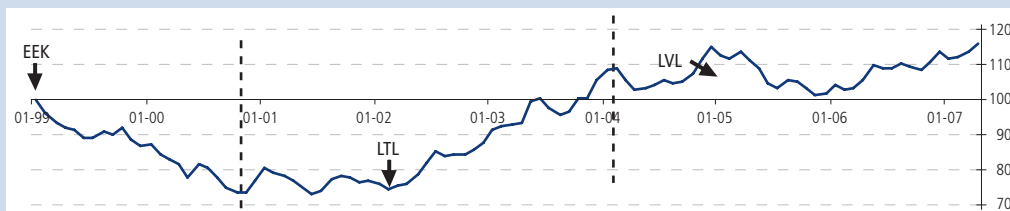
5 According to Vanags, A., Hansen, M.: Inflation in the Baltic states and other EU new member states. Is there a mystery to unravel? BICEPS Report, May 2006.

6 According to the revision as of January 2000, the US dollar counted for 45% of the SDR basket and the euro 29%. According to the latest revision as of January 2006, the US dollar counts for 44% and the euro 34% of the SDR basket.

Changes in the exchange rate regimes in the Baltic region

	Preceding regime	Current regime (pegged to the euro in all three countries)
Estonia (kroon)	currency board (DEM) od 1992	<ul style="list-style-type: none"> • currency board from January 1999 • ERM II participation from June 28, 2004
Latvia (lats)	fixed peg (SDR) od 1994	<ul style="list-style-type: none"> • fixed peg from December 2004 • ERM II participation from April 29, 2005
Lithuania (litas)	currency board (USD) od 1995	<ul style="list-style-type: none"> • currency board from February 2002 • ERM II participation from June 28, 2004

Chart A The USD/EUR exchange rate (1999 M1=100)

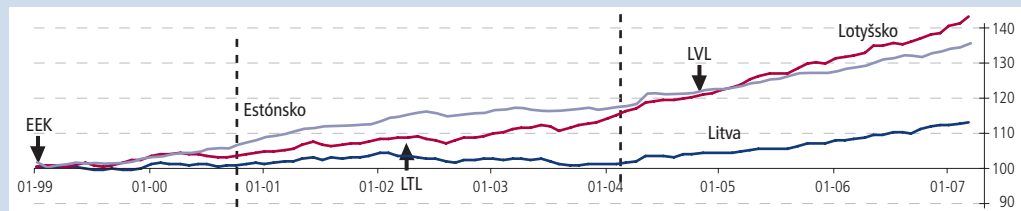


Source: Eurostat and calculations of NBS. A rise in the value represents appreciation of the euro.



Box 1

Chart B HICP indices (1999 M1=100)



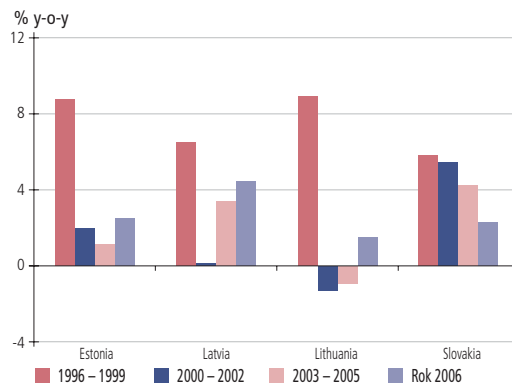
Source: Eurostat and calculations of NBS.

Chart 1 Labor productivity differentials against EU-15



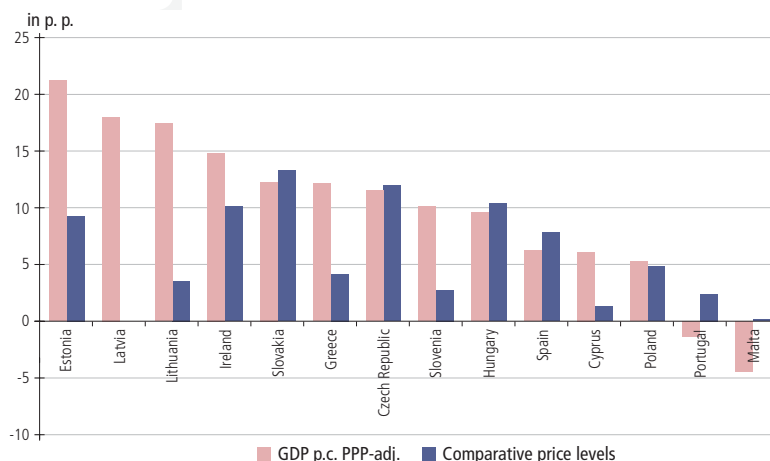
Source: Eurostat and calculations of NBS.

Chart 2 Price component of the REER against 12 partners



Source: Eurostat and calculations of NBS. REER based on the CPI.

Chart 3 Changes in the convergence level against EU-15 (in 2006 against 2000)

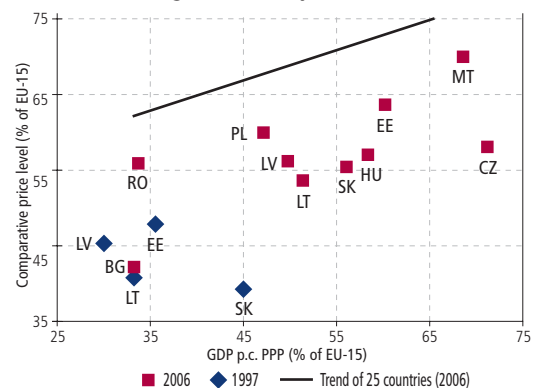


Source: Eurostat and calculations of NBS

creases. The rates of economic growth exceeding 6-11% after 2000 are associated with the low base, to which these economies fell at the beginning, while having reached their 1990ę GDP level only in 2004-2005. By contrast, price convergence, rapid in the initial period, created space for a minimum price growth after 2000.

As a result of the imbalanced development, relation between the price and real convergence in the years 2000-2006 in the Baltic countries appears favorable. Over these six years, the GDP per capita index (purchasing power parity adjusted) increased by 17-21 percentage points cumulatively. Over the same period, the price level in Lithuania and Estonia increased by 3.5 and 9 percentage points respectively, while remaining unchanged in Latvia. When looking at the entire period from the beginning of the 90s this relation would be in a cumulative more balanced as is indicated by data available from 1997.

Chart 4 Convergence in a dynamic view



Source: Eurostat and calculations of NBS.

EE – Estonia, LV – Latvia, LT – Lithuania, SK – Slovakia, RO – Romania, PL – Poland, HU – Hungary, CZ – Czech Republic, MT – Malta, BG – Bulgaria.

Similarly to the convergence of prices and GDP, the development of real exchange rates of the Baltic currencies was characterized by non-homogeneity. In the 90s, the REER (real effective exchange rates) appreciated primarily through differences in price indices (data available from 1995 to 1999 show an average annual appreciation of more than 11-16%). In Estonia, the real appreciation slowed down considerably after 2000 due to a markedly lower inflation differential. In the other two countries, the slowdown in appreciation after 2002 was caused, in addition

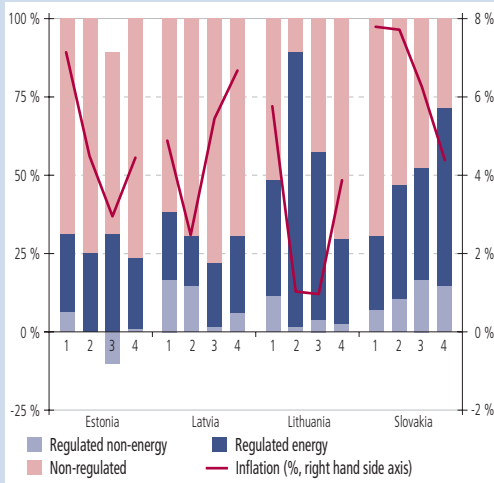


Box 2

Deregulations in the Baltic Region and in Slovakia

Real appreciation of converging economies usually reflects the costs and price adjustments. The experience of Baltic countries shows that price convergence can take various forms. We can assume that the overall price convergence in these countries was rapid in the initial period and has decreased temporarily after 2000. However, what is the situation in the Baltics regarding prices that are determined not by the market, but are the result of administrative measures?

Contributions to HICP inflation



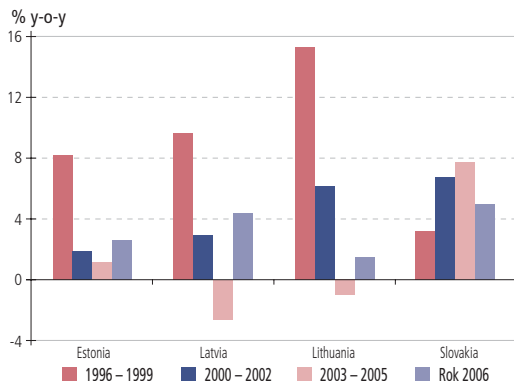
Source: Eurostat and calculations of NBS.⁷
 1 is the average over 1997-1999, 2 over 2000-2002, 3 over 2003-2005, 4 the year 2006.

From the HICP basket we have separated goods and services, whose prices are subject to regulation (including consumption taxes). These goods and services account for 25-30% of inflation in the Baltics, while their share in Slovakia exceeded 70% in 2006. Regulated energy items represent almost the whole contribution of the regulated items in these countries, the corresponding share in Slovakia reached about 50% in 2006. An exception in this context was Lithuania in the years 2000-2005, which recorded a high share of regulated energy items, this, however against the background of a 1% headline HICP inflation rate.

Data on energy prices which count for the majority of the regulated prices are available only from 2003-2004 for the Baltic countries, thus we are not sure about the extent these prices were released within the rapid price adjustment in the 90s. Based on the current level of energy prices in the particular European countries, one can assume that the overall extent of deregulations in the Baltic region is probably lower than for example in the Slovak economy. Electricity prices in the Baltic region stand approximately at 50-60% of the EU-15 average and gas prices at 40-57%, while in Slovakia they exceed 100% and 80% respectively. The comparatively lower energy prices in the Baltic region, however, are not only the result of regulatory policy, but they are also associated with the specific contract terms at their purchase (see Box 3 for details).

7 According to the IMF study *Republic of Lithuania: Selected Issues, Part II: Inflation in Lithuania*, IMF Country Report No. 06/163, May 2006. *Commodities in the HICP basket are divided into the following, mutually overlapping groups: tradable and non-tradable, energy and non-energy and regulated and non-regulated items. This breakdown of inflation is for informative purposes only, it is not identical with the breakdown of inflation according to the national statistical methodology.*
 8 The REER of Latvia depreciated on average by more than 5% in the years 2003-2005 after the preceding appreciation period. In 2006, the NEER of Baltic countries remained on average unchanged in year-over-year terms.

Chart 5 Average change in REER against 12 partners



Source: Eurostat and calculations of NBS. REER based on the CPI.

to this factor, also by a gradual stabilization of the NEER (nominal effective exchange rate) as a result of the exchange rate fixation to the euro⁸. (Estonia operated a currency board pegged to the German mark already from 1992, thus its NEER virtually has not changed over the entire period till today).

These economies currently keep their favorable labor productivity increases as compared to the

Chart 6 Average change in NEER against 12 partners



Source: Eurostat and calculations of NBS.

EU-15. The present situation in the Baltic region is, however, characterized not only by the real convergence (fundamentals), but also by imbalances manifesting themselves in demand pressures. The price growth, minimal after 2000, has thus accelerated again.

In terms of GDP and price convergence to the EU-15, the Slovak economy is at a level compa-



9 According to the estimates of the National Central Banks and of the European Commission, DG ECFIN.

able to that of the Baltic countries. However, the path of our economy has been considerably different:

1. A kind of difference in the framework is the non-/use of fixed exchange rates. The Baltic countries have adopted the currency board or fixed peg regime in the first half of the 90s and have kept up with till today. Slovakia had a fixed exchange rate regime from its independence in 1993 and switched to a managed floating regime in October 1998. The koruna has been in the ERM II mechanism since November 2005.

2. In the case of Slovakia, the development has been more balanced as compared to the Baltic region – in terms of GDP, prices as well as REER. The economy has been reaching a somewhat higher dynamics of prices than of GDP, but the difference between those two has been minimal (with the exception of the years 1999-2000, followed by stabilization reforms).

It is the preference for a fixed exchange rate regime what could have, in a certain way, contributed to the less balanced development in the Baltic countries. In a certain period, the exchange rate fixation helped to stabilize these economies, in the later period of strong growth, however, this monetary policy strategy might have been limiting. Already since the 90s the region has been receiving large amounts of foreign direct investment, an important prerequisite of dynamic growth. The Baltic countries, however, have been missing the possibility to influence their fast growing economy through own monetary policy, nor do they have floating exchange rates, etc.

3. Real appreciation of the koruna was more than the Baltic currencies influenced by nominal appreciation. The nominal exchange rate remains an active channel of real appreciation even after entry of the koruna into the ERM II mechanism. On the other hand, the REER of the koruna has been, to a considerable extent, influenced also by the development of the inflation differential. The price adjustment in the case of Slovakia is continuous and has been passed through in real appreciation more continuously than in the Baltic countries. This also concerns administrative prices, which have been released in deregulations from 1998.

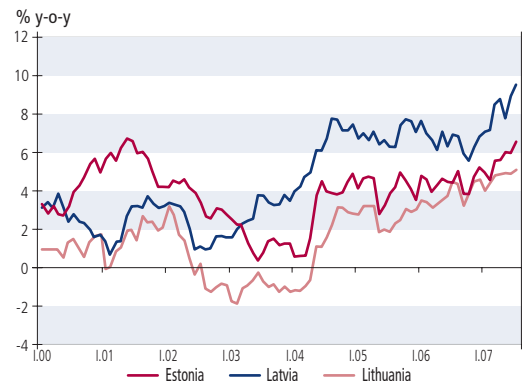
4. An advantage for our further convergence could be the period of floating exchange rate (from October 1998), with the economy undergoing a number of changes. During that period, fundamental structural measures were launched towards consolidation of the economy and of the banking sector and we witnessed a shift from a transition to a converging economy. Slovak inflation has been stabilized at levels close to the inflation rate in the euro area under the floating exchange rate regime, while the price-exchange rate relations could adapt in a flexible way. Conversion parity set at a level that will take into account the current parameters of the economy could provide a favorable background for the fur-

ther development of our equilibrium exchange rate.

2. REASONS OF AN ACCELERATED PRICE DEVELOPMENT

Over the last decade, the Baltic region made a considerable progress in convergence thanks to marked productivity increases. The current situation however reflects not only the favorable development of fundamentals, but also considerable domestic and external imbalance. The region became overheated as early as in 2005, while the output gap is expected to remain positive also in this and the following years⁹. This is backed by a historically strong economic growth driven by domestic demand, exceeding in its dynamics the GDP growth due to the negative contributions of net exports (growing current account deficits). Gradually the strong demand has been reflected in accelerating inflation. As a result of overheating, the previously favorable situation changed even in Lithuania as the last one among Baltic countries.

Chart 7 Development of the HICP inflation



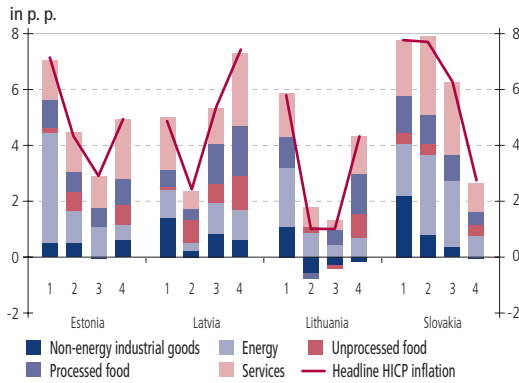
Source: Eurostat.

Although the development of inflation is not (or has not been) uniform in these three economies, it has some common features. From the beginning of the 90s until today, it took the form of an imaginary bow starting at three-digit numbers, in 1993 still exceeding 90-110% (Estonia, Latvia), or even 400% (Lithuania). Stabilization policy, which for example in Lithuania was supported by exchange rate policy, succeeded in achieving relatively low inflation levels in 2000-2003. A pick-up in inflation was associated with the EU accession of the Baltic countries in May 2004; in Latvia, inflation has accelerated already one or two years before. The favorable effects of stabilization measures from the previous period definitively ended in 2006 and in the first quarter of 2007, with a further acceleration in the price dynamics to 4-8% in all three countries.

What contributed to the turn in the development of Baltic inflation over the last two-three years? In terms of statistics, inflation has risen mainly due to a higher dynamics in the prices of services and food as compared to the previous

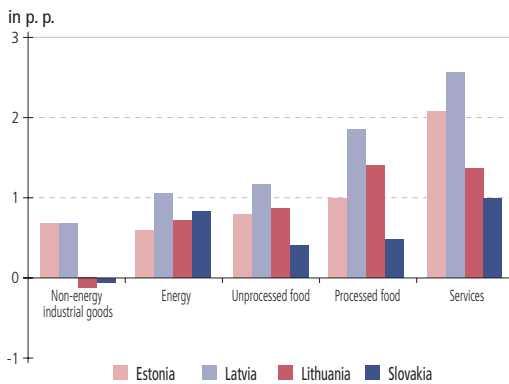


Chart 8 Contributions to HICP inflation



Source: Eurostat and calculations of NBS. 1 is the average over 1997-1999, 2 over 2000-2002, 3 over 2003.2005, 4 the year 2006.

Chart 9 Contributions to HICP inflation (average 2006-1Q2007)

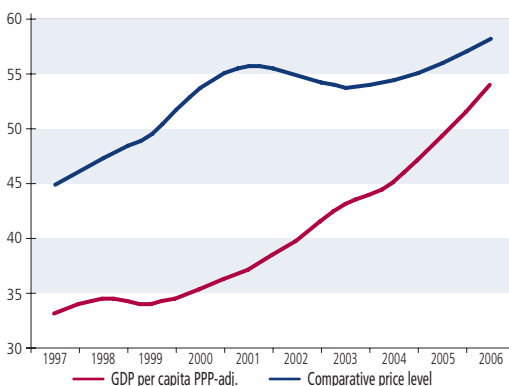


Source: Eurostat and calculations of NBS.

years; energy prices have had a changing effect on inflation depending on the prices of energy commodities. Several factors stand behind the higher inflation figures:

1. Acceleration in inflation as compared to the previous period is partly associated with the rapid real convergence. The period after 2000 up to 2005-2006 appears to be ideal, having both price stability and strong real convergence. We think however that this favorable combination has been enabled by the uneven development in the previous years. The price convergence, rapid in the initial period, seemed to pause temporarily

Chart 10 Convergence dynamics – average for the Baltic region (EU-15=100)

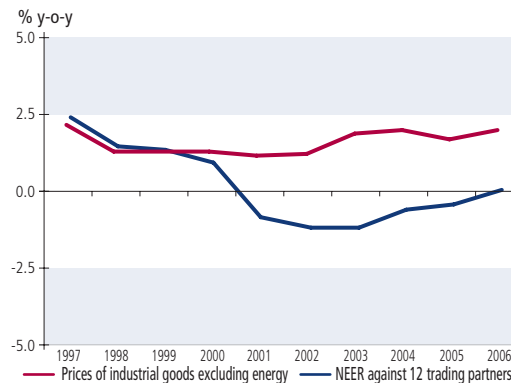


Source: Eurostat and calculations of NBS.

after 2000. We tend to think that, to a certain extent, the current price growth is more adequate to the rapidly converging economies than is a close to zero inflation rate or even deflation.

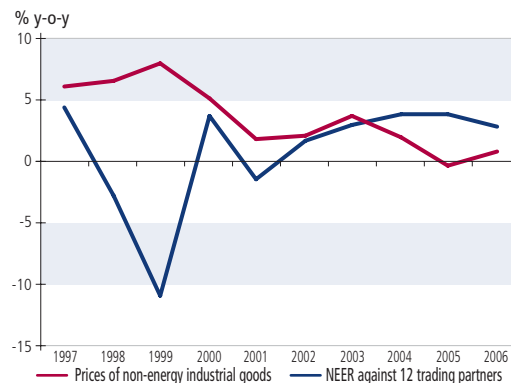
2. Inflation profile of these countries is to some extent influenced by the absence of a floating exchange rate regime. On the one hand, the fixed exchange rate regime, along with other measures, has contributed to the stabilization of these economies; on the other hand, they are currently missing the dampening effect of the exchange rate in the prices of non-energy tradable goods and in food prices. The NEER of the Baltic currencies against 12 up to 41 trade partners, have tended to stabilize in terms of year-on-year changes over the last 4 to 5 years.

Chart 11 Exchange rate influence on prices of tradables (average for Latvia and Lithuania)



Source: Eurostat and calculations of NBS. Both variables have a similar development in these two countries, therefore it is possible to illustrate their relationship using averages. A rise in NEER represents appreciation.

Chart 12 Exchange rate influence on prices of tradables (Slovakia)



Source: Eurostat and calculations of NBS. A rise in NEER represents appreciation.

Several other factors are associated with the contribution of food prices to inflation in the Baltic countries. Headline HICP inflation is quite sensitive to this component, given its relatively high share in the basket. This counts for 29 to 34% on average (against 19% in the euro area). The growth of food prices (both processed and unprocessed) has been high from the EU accession onwards. This is linked to the opening of EU markets, when the remaining export tariffs were



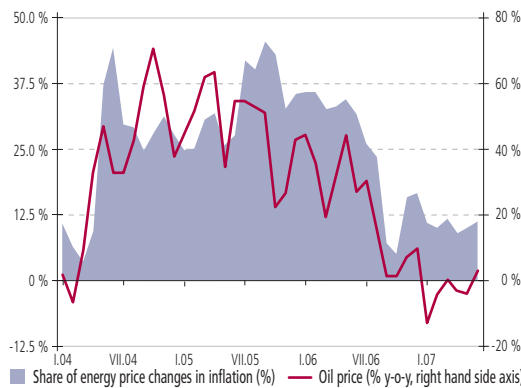
10 According to the 2006 Convergence Report on Lithuania. European Economy Special Report No. 2/2006, European Commission.

11 Overall, our prices of goods are at a level exceeding 70% of the EU-15 average, the prices of services are at a level exceeding 35%. Estonia is somewhat further in terms of price convergence, Latvia is approximately at the same level as Slovakia and Lithuania is slightly lagging behind Slovakia (according to Eurostat data for 2005).

abolished and, by contrast, the new countries gained access to subsidies on exports to third countries. At the same time, food safety regulations have been harmonised. In Lithuania, this, along with a shifting domestic supply, has caused a sharp increase in the prices of unprocessed food. With a changing intensity this effect appears also in other years after the EU accession¹⁰. Food prices also reflect changes in indirect taxes, especially in the value added tax.

3. Inflation in the Baltic countries responds quite sensitively to changes in the prices of energy commodities. Share of energy prices in inflation in the second half of 2006, characterized by decreasing oil prices, gives evidence to this. The sensitivity is given by the weight of energy prices in the HICP basket being higher than for example in the euro area (the average for 2006 and 2007 is some 12-13% as compared to 9.4%). Moreover, the energy intensity of these economies is several times higher. In a special way, energy price-making in the Baltic countries is influenced by the energy market (Box 3). What is important for inflation development in the near future, these countries will face further adjustments of energy prices due to their hitherto relatively low levels compared to other European countries.

Chart 13 Inflation sensitivity to prices of energy commodities (average for the Baltic region)



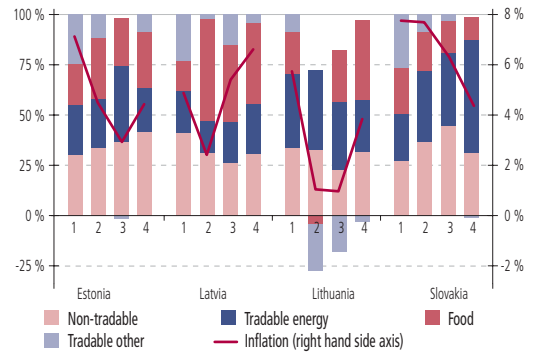
Source: Eurostat and calculations of NBS. Contributions of energy prices to inflation exhibit similar developments in the Baltic countries, therefore it is possible to illustrate their relationship using averages. Oil price in USD/barrel.

4. Overall, however, the issue of accelerating inflation in the Baltic region is a wider problem. Both the prices of services and prices of tradable goods point to this. The share of the so-called tradable items in HICP inflation has increased in all three economies along with the acceleration of headline inflation. Of course, this should be also attributed to the influence of tradable energy items and to the relatively high shares of food prices. Nevertheless, the increase in the share of other tradable items in headline inflation (in the case of Lithuania and Estonia, a loss of their dampening effect) is evident.

Inflation seems to reflect the internal and external imbalances these economies are facing. Links to the inflation behavior can be seen in demand pressures accompanying the positive out-

put gap, but also in the tense situation in the labor market with a deteriorating relation between the growth of real productivity and wages. The presence of demand pressures in the economies is reflected not only in the development of prices, but also in growing current account deficits.

Chart 14 Contributions to HICP inflation



Source: Eurostat and calculations of NBS. 1 is the average over 1997-1999, 2 over 2000-2002, 3 over 2003-2005, 4 the year 2006.

In terms of price convergence as compared to the EU-15 average, Slovakia reaches similar figures as the Baltic region. A considerable level of the price catching-up process still is to pass in both Slovakia and the Baltic countries.¹¹ There are, however, differences between Slovakia and the Baltic countries in the development of inflation.

1. The price adjustment in Slovakia was rather gradual and spread more evenly over the entire period from the beginning of the 90s. In the market-made proportion of the price adjustment, Slovakia and the Baltic countries are in a similar situation. However, differences exist in administered prices, where Slovakia has probably got further. In particular, this counts for the energy prices, reaching in Slovakia a level almost comparable to that of the EU-15 (energy has a weight of 18% in our HICP basket). Communication prices are approaching a similar level. This represents an advantage for Slovakia in terms of the future price development. Further administered price adjustments pose a lower risk to inflation compared to the Baltic countries.

2. A fundamental difference lies in the influence of the exchange rate on Slovak inflation, respectively its absence in the case of Baltic countries. The appreciation of the NEER of the koruna seemed to have an (at least moderate) dampening effect on the prices of tradable goods, especially food prices. We may expect that after the loss of the floating exchange rate of koruna against the euro, the NEER of koruna will stabilize similarly as in the Baltic countries, and that Slovakia will lose this dampening effect. In reality, however, this influence is relatively weak in our economy – over the last three years, the price growth of non-energy industrial goods has been reaching 0.6% on average, i.e. the same level as in the euro area, while in the Baltic countries this figure was between -0.3% and 2.7%. Industrial durables recorded a similar develop-



Box 3

The Energy Market in the Baltic Countries

The position of the Baltic countries in the energy market is quite specific. In the near future, the energy market is generally expected to have a rather important influence on the energy prices in these countries, this for several reasons:

1. Energy consumption, especially that of natural gas, should grow further according to estimates. The region depends almost exclusively on the natural gas supplies from Russia.
2. Final consumer energy prices are only at around 50 to 60% of the EU-15 average which is, in part, the result of more favorable contracts and, in part, also by regulatory policy (low pass-through of the increase in import prices into the final consumer price). Within 2-3 years, an import price increase of natural gas by more than 30% is

expected in the Baltic countries due to the expansive strategy of Gazprom. The direct effect on HICP inflation with a weight of 0.3 to 1.3% should be low, it could, however, be transmitted into the prices of other goods and affect inflation expectations.¹²

3. A special situation regards Lithuania which in the contrary to Estonia and Latvia is not primarily bound to natural gas. Lithuania's energy consumption is divided between oil and nuclear energy. Delays in restoration of processing capacities and problems with oil supplies occurred already in late 2006.¹³ Regarding the nuclear energy, the Ignalia reactor¹⁴ is, in line with EU regulations, due to be closed by late 2009 and new facilities should operate only from 2015-2016.

After all, the energy market thus poses an upward risk to inflation in the Baltic countries.

12 According to Energy supply in Central Europe and the Baltics, IMF Regional Office Note, July 2006.

13 According to European Economy No. 2/2007, European Commission Forecast Spring 2007.

14 According to Eastern European Outlook, SEB Economic Research, March 2007.

ment. A more marked difference is in the dynamics of food prices – they have reached a level of 2.3% in Slovakia (1.4% in the euro area) and 4.2% to 8.5% in the Baltic countries.

3. What can help us to maintain a sound inflation development? The influence of the exchange rate on the prices of tradables or volatility of energy prices are more or less partial issues

our economy will have to face just like the Baltic countries. The Baltic experience shows that rather the overall macroeconomic stability appears to be the key prerequisite for a sound inflation development – particularly a healthy relation between productivity and wage growth, as well as a favorable relation between the growth of GDP and of domestic demand.

To be continued in Issue 1/2008