

PRICE STABILITY FOR ROMANIA. RESPECT OF THE REFERENCE VALUE

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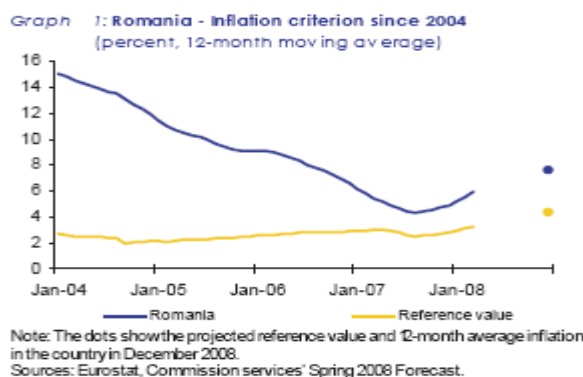
The Protocol on the convergence criteria not only requires Member States to have achieved a high degree of price stability but also calls for a price performance that is sustainable. The requirement of sustainability aims at ensuring that the degree of price stability and inflation convergence achieved in previous years will be maintained after adoption of the euro. This implies that the satisfactory inflation performance must essentially be due to the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflecting the influence of temporary factors.

Keywords: stability, convergence, performance.

Cod JEL lucrare: F01, F15, O10, O20.

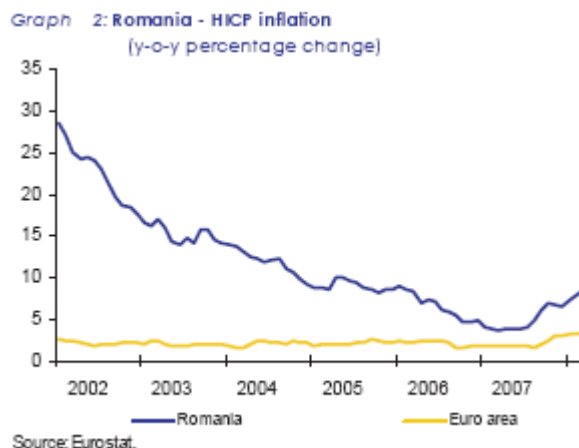
1. Recent inflation developments

The 12-month average inflation rate for Romania, which is used for the convergence assessment, has been above the reference value since EU accession. The difference between 12-month average inflation and the reference value initially decreased to 1.8 percentage point in June-September 2007, and it gradually increased again thereafter. In March 2008, the reference value was 3.2%, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Denmark, Malta and the Netherlands) plus 1.5 percentage points. The average inflation rate in Romania during the 12 months to March 2008 was 5.9%, well above the reference value of 3.2%, and it is likely to move further away from the reference value in the months ahead.



As a result of strong stabilisation policies since the beginning of the century Romania succeeded in achieving rapid disinflation. Inflation dropped to single-digit levels in 2005 and decreased further until the spring of 2007. The appreciation of the currency between end-2004 and mid-2007 was an important element behind this development. In Romania, the pass-through of the exchange rate is substantial and fast and thus contributed significantly to dampening price pressures.

Disinflation also reflected a broad range of other factors, including prudent monetary policies, relatively contained budget deficits until 2005, a favourable development of agricultural prices, relatively strong productivity gains, and lower inflation expectations. HICP inflation in Romania averaged 4.9% in 2007, from 6.6% in the preceding year. Headline HICP inflation reached a low point of 3.7% in March 2007. However, underlying inflationary trends, as measured by core inflation, remained higher with the economy increasingly showing signs of overheating.



From August 2007, headline HICP inflation accelerated sharply to 8.7% in March 2008. The marked pick-up in inflation initially largely reflected large upward supply shocks in agricultural prices. These were partly due to domestic factors – notably the severe summer drought which affected negatively domestic agricultural production – and partly followed from the sharp increases in agricultural commodity prices on the world market. The impact of the latter on final consumer prices for foodstuffs at the national level tends to be magnified for catching up countries such as Romania, where the share of commodity input prices in total costs (including distribution and retail) is relatively high. The impact of the significant weakening of the leu and of the sharp increase in fuel prices (from the fourth quarter of 2007 onwards) added to the pick-up in inflation from the second half of last year onwards.

Core inflation – defined as year-on-year headline HICP inflation excluding energy and unprocessed food – has picked broadly up in tandem with headline inflation and stood at 8.2% in March 2008. Alternative measures of core inflation as used by the central bank – defined in terms of market prices and market prices excluding volatile prices – have also moved up sharply since the spring of 2007.

Persistently strong wage and domestic demand pressures added to supply-side price shocks, fuelling the uptrend in consumer prices. These reflected brisk credit growth, a buoyant real estate market, a loose fiscal stance, and strong gains in household disposable income. The most recent developments thus suggest that inflationary pressures have become more entrenched amidst signs of an upward adjustment in inflation expectations.

As regards subcomponents of the HICP, services prices have been an important driver of inflation.

Increases in energy and food prices also accounted for a substantial part of overall inflation in the past few years, with the sharp increase in food prices as of the summer of 2007 being a particularly large upward shock. By contrast, increases in nonenergy industrial goods remained more subdued helped by global price trends in a closer integrated world market and, for the first part of the assessment period, also by the strengthening of the effective exchange rate.

2. Underlying factors and sustainability of price performance

Real GDP growth has been very strong in the past few years, despite a temporary dip in 2005. Economic growth averaged around 6.5% between 2004 and 2007, largely buoyed by domestic demand. While the estimation of potential growth and output gaps is surrounded by large uncertainties for fast-changing economies such as Romania, Commission services' estimates suggest that buoyant growth led to a substantial positive output gap from 2004 onwards. For 2007, this positive output gap is estimated at 3% of GDP and is expected to only decrease slightly in 2008. A loose fiscal stance further contributed to demand pressures in the last few years. In 2006-7, the budgetary stance, as measured by the cyclically adjusted balance, deteriorated to a deficit of 3.4% of GDP. For 2008 and 2009, a further fiscal loosening is expected.

Progressive disinflation, coupled with the strengthening of the leu, allowed the National Bank of Romania (NBR) to cut official interest rates by from 21.25% at the beginning of 2004 to 7% by end-June 2007. The degree of monetary policy easing was mitigated by the tightening of other policy instruments at the disposal of the NBR. In 2006, measures included the rise in the reserve ratios for both leu-denominated liabilities (from 16 to 20%) and foreign exchange denominated liabilities (from 35 to 40%), along with closer supervision of non-bank financial institutions. Monetary conditions eased substantially from the summer of 2007 onwards due to the weakening of the leu coupled with lower real interest rates resulting from the pick-up in inflation. The NBR did respond by raising official interest rates by 250 basis points in four steps between November 2007 and March 2008. In addition, in February 2008 the NBR also announced additional prudential rules, including higher provisioning for foreign exchange denominated credits extended to unhedged borrowers. Rapid financial deepening facilitated by large inflows of funds to the financial sector, which is characterised by a high degree of foreign ownership, fuelled very rapid credit growth, adding substantially to demand pressures. The growth rate of domestic credit to the non-financial private sector reached 61% in 2007, a rate quite similar to 2006. Credit growth is skewed towards lending to households; the growth of household credit reached 82% in 2007, a growth rate that has remained fairly stable since 2006. A significant part of household borrowing is in the form of consumer credit, feeding directly into domestic demand.

Table 1

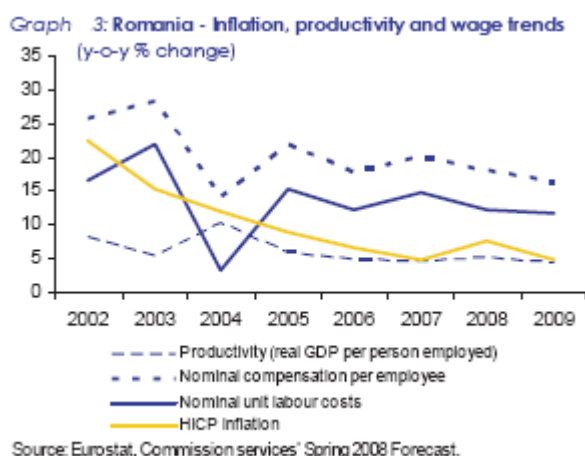
Romania - Other inflation and cost indicators		(annual percentage change)						
	2002	2003	2004	2005	2006	2007	2008	2009 ²⁾
HICP inflation								
Romania	22.5	15.3	11.9	9.1	6.6	4.9	7.6	4.8
Euro area	2.4	1.9	2.1	2.2	2.2	2.1	3.2	2.2
Private consumption deflator								
Romania	21.4	15.2	13.9	7.3	5.2	4.7	7.0	4.6
Euro area	1.9	2.1	2.1	2.1	2.2	2.0	2.8	2.1
Nominal compensation per employee								
Romania	25.9	28.3	13.9	22.1	17.8	20.2	18.1	16.4
Euro area	2.7	2.8	2.5	2.1	2.4	2.4	3.3	2.9
Labour productivity								
Romania	8.1	5.3	10.3	5.8	4.9	4.7	5.2	4.2
Euro area	0.5	0.9	1.8	1.1	1.5	0.9	0.9	1.0
Nominal unit labour costs								
Romania	16.5	21.9	3.3	15.4	12.3	14.8	12.3	11.6
Euro area	2.3	2.1	0.8	1.1	1.0	1.5	2.4	1.9
Imports of goods deflator								
Romania	15.8	15.4	8.7	-3.6	-1.0	-5.9	11.0	2.0
Euro area	-2.9	-2.2	1.3	3.7	4.2	1.2	2.5	1.6

Source: Eurostat

Moderation in wage increases had been an important factor in Romania's disinflation at the beginning of the century. But the growth of wages and unit labour costs has been rapid in recent years, reflecting buoyant economic activity and increasing tightness on the labour market, notably in the construction sector and for skilled labour.

Large-scale emigration contributed to shortages in key segments of the labour market. In the past three years, overall compensation gains remained well above the growth rate of labour productivity, which hovered around 5%, after having peaked at 10% in 2004. Despite strong labour productivity gains the growth rate of nominal unit labour costs (ULC) remained quite high, reaching some 15% in 2007, with only a slight moderation expected for 2008. Increases in unit labour costs are thus expected to continue feeding into domestically generated inflation in 2008.

Public sector wage discipline has been lacking, as in the last few years public sector wage gains even increased faster than those in the private sector. The flexibility of the decentralised wage setting process in Romania is hindered by certain institutional features of the wage-setting process, notably that wage agreements in the public sector appear to provide a signal to private sector settlements. With signs of overheating becoming apparent and inflation expectations increasing, there is a risk that wages may not adjust swiftly enough to avoid deterioration in competitiveness.



Falling import prices, as measured by the import of goods deflator in the national accounts expressed in national currency, supported disinflation into the first half of 2007. The effective appreciation of the leu was an important factor determining the prolonged fall in import prices between 2005 and the first part of 2007. Decreases in import prices for non-energy industrial durables were the most pronounced, related to increased global market integration.

The nominal effective exchange rate of the leu experienced a strong trend appreciation from 2004 to the summer of 2007. In effective terms the leu appreciated by around 30%, this being an import factor supporting the decline in inflation. From August 2007, however, the nominal effective exchange rate of the leu started to weaken considerably and had depreciated by nearly 15% in March 2008.

The dampening impact of import prices rapidly reversed from the second half of 2007 onwards, as the substantial effective weakening of the leu compounded the upward impact of rises in global commodity prices, inducing a sharp rise in Romanian import prices. The total contribution of energy prices to HICP inflation decreased from around 3.5% in 2005 to just above 1% in 2007, the decline mainly mirroring more subdued price increases charged by energy utilities. But in the

first months of 2008, a marked rise in gas and fuels prices led to a rise in the contribution of energy prices to overall inflation. In the area of services prices, international competitive pressures and the linking of tariffs to the exchange rate of the leu to the euro helped push down consumer prices for telecommunications. However, the reversal in the exchange rate induced a sharp pick-up in telecommunications prices from December 2007 onwards.

In Romania, adjustments in administered prices, which have a relatively high weight of around 25% in the HICP basket, added noticeably to headline HICP inflation in the past few years .

However, the contribution of administered prices to harmonised inflation decreased from above 3 percentage points in 2005 to around 1.5 percentage point in 2007. This falling contribution mainly reflected trends in administered utility prices. The impact of marked increases in the prices charged for gas, electricity and heating was mainly concentrated in 2005 and 2006. In 2008 likely further increases in utility prices, reflecting the lagged impact of higher energy prices on world markets and the exchange rate depreciation, are expected to add to inflation.

In addition, adjustments in excises have also been exerting an upward impact on HICP inflation, estimated. Increases in excises on petrol, diesel and tobacco products (which have to be implemented to reach the minimum level required in the EU) are estimated to contribute significantly to headline inflation in 2008 and 2009 as prevailing derogations expire on 1 January 2010.

Inflation performance in 2008 will reflect several factors, notably the lagged pass-through of exchange rate movements, the development of prices for agricultural products and commodities, and the impact of demand pressures reflecting buoyant wage and credit growth and a loose fiscal stance. Against this background, the Commission services' Spring 2008 Forecast expects average HICP inflation to increase significantly to 7.6% in 2008, compared to 4.9% in 2007.

Incipient overheating points to several upside risks to the inflation outlook. Timely adjustments in the labour, real estate and credit markets will be crucial in redressing them. The risk of a further loosening of fiscal and in particular public sector wage policy could pose additional pressures on inflation. Persistent inflation further risks adding to inflation expectations.

In 2006, the level of consumer prices in Romania was at some 57% of the EU average, with the relative price gap widest for services. This suggests potential for further price level convergence in the long term, as income levels (about 39% of the EU-27 average in PPS in 2006) increase gradually towards the EU average.

Medium-term inflation prospects will depend crucially on a robust policy framework that would help anchor inflation expectations at a lower level and avoid second-round effects of external price shocks. Fiscal discipline will be important to ensure a balanced policy mix and help ensure a sustainable inflation performance conducive to growth, in particular in terms of the public sector wage setting and the quality of public finances.

Aligning wage growth with productivity developments will be crucial to safeguard competitiveness and avoid wage-price spirals. Advancing structural reforms to improve the functioning of labour and product markets and enhance competition is warranted with a view to contain inflationary risks.

3. Conclusions

The average inflation rate in Romania during the 12 months to March 2008 was 5.9%, well above the reference value of 3.2%, and it is likely to move further away from the reference value in the months ahead.

Inflation in Romania recorded a sustained downward trend for a number of years until 2006, supported *inter alia* by an appreciation of the leu since 2004. Headline HICP inflation reached a minimum of slightly below 4% in early 2007 but increased markedly afterwards partly driven by a sharp upward movement in agricultural prices, which reflected both the severe drought in the summer of 2007 and trends in world market prices. Persistent wage and demand pressures,

increases in fuel prices and the significant weakening of the leu from the second half of 2007 added to the pick-up in inflation. HICP inflation averaged 4.9% in 2007 and is projected to increase markedly in 2008, to slightly below 8% on average, before decelerating in 2009 to close to 5% as the inflationary impact of commodity price increases fades.

The relatively low price level in Romania (57% of the EU average in 2006) suggests potential for price level convergence in the long term. Romania does not fulfil the criterion on price stability. In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Romania does not fulfil the conditions for the adoption of the euro.

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