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PRESS RELEASE

Inflation differentials in the euro area: size, causes, economic policy implications and relative position of Belgium
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In recent years, the size and persistence of inflation differentials in the euro area has been the subject of numerous analyses and empirical studies. In EMU, this phenomenon may be important because these differentials may influence the effectiveness of the Eurosystem's monetary policy. In order to take account of these inflation differentials, in particular, the Eurosystem recently clarified the definition of price stability, specifying that the annual increase in the HICP should be below, but close to, 2 p.c. in the euro area. Moreover, since - having relinquished their monetary sovereignty - the states are no longer able to correct national imbalances by adjusting their monetary policy, and since the Eurosystem has no instrument to deal with these divergences, it is important for EMU member countries to take adequate measures, in certain cases, to reduce these differentials.

This article aims to analyse inflation differentials between Belgium and the euro area. Since monetary unification, these differentials do not appear to be either significant or persistent. Moreover, they do not show any upward or downward bias. Despite these findings, empirical studies relating to the "Balassa-Samuelson" effect have concluded that the inflation rate in Belgium should be systematically higher than the average rate in the euro area. According to that theory, the differentials between countries in terms of the relative productivity of tradable goods as opposed to non-tradable goods give rise, under certain assumptions, to changes in the real exchange rate, and - in a monetary union where the nominal exchange rate is fixed - to inflation differentials. This article examined these conclusions, which at first sight appear paradoxical. As in earlier studies, Germany was taken as the reference economy.

First, on the basis of value added data as in earlier studies, the article establishes that the increase in the relative productivity of tradable goods as opposed to non-tradable goods has been greater in Belgium than in Germany over the past thirty years, and this has been associated with a more marked rise in the relative price of the non-tradable goods sector. This initial finding is in line with the results of earlier studies and with theoretical predictions.

On the basis of a breakdown of the real exchange rate, the analysis then shows that the real exchange rate of the tradable goods sector has depreciated sharply in relation to Germany over the period considered, offsetting the effect of the positive differential in relative prices. This failure to satisfy a crucial assumption underlying the "Balassa-Samuelson" theory, namely purchasing power parity in the tradable goods sector, thus makes it possible to understand why earlier studies – which explicitly considered that this assumption was fulfilled – were able to find an inflation rate for Belgium which was structurally higher than the average rate for the euro area, whereas in the past no real appreciation was observed for the economy as a whole.

Finally, the article examines the real exchange rate measured on the basis of the consumer price index instead of using the value added deflator. Indeed, since the consumer price index is the benchmark for the monetary authorities, it is essential to examine to what extent the conclusions of the analysis of the value added deflator can be extended to the HICP. Research on the basis of that price index reveals a far less pronounced contribution from the difference in relative prices, and the maintenance of purchasing power parity between Belgium and Germany in the tradable goods sector; the overall implication of this is a relative stability in the real exchange rate of the economy as a whole.

In conclusion, there seems to be no structural reason why inflation should be systematically higher in Belgium than in the euro area. It appears that the inflation differentials between Belgium and the euro area neither significant not persistent. From that point of view, the ECB's monetary policy therefore seems appropriate to the Belgian economy in the current environment.

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