Asymmetric growth and inflation developments in the acceding countries: a new assessment

This paper discusses the asymmetry of growth and inflation developments in the new Member States of the EU vis-à-vis the euro area over the years 1995-2003. The extent of these asymmetries is an important indicator of the economic costs these countries might incur when adopting the euro. If a new Member State is subject to considerable asymmetries, there may be a case for keeping more independent monetary or exchange rate policies as an adjustment mechanism. Although previous studies mainly concentrated on diverging developments in economic activity, the asymmetric behaviour of inflation is equally important in the perspective of ERM II and the adoption of the euro. As a consequence, both kinds of asymmetry are analysed.

We use a quantitative approach relying on small econometric models (Structural Vector Autoregressive models), one model per country, with growth and inflation in the country and the euro area as dependent variables. The models combine an explanation in terms of country-specific and euro area shocks, with a further split between supply and demand shocks. These four shocks may all create asymmetries in growth or inflation vis-à-vis the euro area. It is evident for country-specific supply or demand shocks but euro area supply or demand shocks may also create asymmetries if the response of the country to the euro area shocks differs from the euro area response.

More specifically, we measured asymmetries by computing the standard deviations of growth (inflation) differentials vis-à-vis the euro area that, making use of the econometric models, can be attributed to each type of shock. With this kind of measure, we not only take into account the traditional correlations between growth (inflation) rates in the country and the euro area but we also pay attention to differences in growth (inflation) volatility that may require different monetary policies.

It appears that country-specific shocks are the main source of growth or inflation divergence, rather than the distinct way in which the new Members react to euro area shocks. But whereas country-specific supply shocks are mainly responsible for growth divergence, country-specific demand shocks are mainly responsible for inflation asymmetry. Hence, a low asymmetry in terms of growth does not necessarily imply a low asymmetry in terms of inflation, although the latter is particularly important for countries aiming to join the euro area. This result is not very surprising as the structural shocks behind inflation and growth asymmetries are of a very different nature.

The economic and institutional developments in the new Member States over the last decade suggest that country-specific shocks might be on the fall. The quantitative analysis confirms the intuition. Country-specific supply and demand shocks were clearly lower over the last four years of the sample period in a majority of countries. However, the recent developments of the supply shocks in Estonia and Poland or of the demand shocks in Hungary testify that the trend may break and that improvements cannot always be taken for granted.