

Box 1

RECENT INFLATION DEVELOPMENTS IN THE NEW EU MEMBER STATES AND THE IMPACT OF EU ACCESSION

This box briefly describes the main factors behind recent inflation developments in the new EU Member States. Before EU accession, inflation decreased considerably in these countries. In 2003, their weighted average HICP inflation had reached a low of 1.9%, compared with 2.1% in the euro area (see table). In the context of EU accession, however, inflationary pressures picked up rapidly in the first half of 2004, reaching 4.8% in the third quarter. Thereafter, inflation started to gradually ease again in most of the countries, reflecting a downward base effect on annual inflation rates as the inflationary impact of EU accession subsided, and stood on average at 2.2% year on year in the fourth quarter of 2005.



HICP inflation in the new EU Member States

(annual percentage changes)

	2001	2002	2003	2004	2005	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1	2005 Q2	2005 Q3	2005 Q4
Czech Republic	4.5	1.4	-0.1	2.6	1.6	2.1	2.4	3.0	2.7	1.4	1.2	1.6	2.2
Estonia	5.6	3.6	1.4	3.0	4.1	0.6	3.2	3.9	4.4	4.5	3.6	4.3	4.0
Cyprus	2.0	2.8	4.0	1.9	2.0	1.0	1.2	2.5	2.8	2.5	2.1	1.7	1.9
Latvia	2.5	2.0	2.9	6.2	6.9	4.3	5.8	7.4	7.2	6.7	6.7	6.7	7.5
Lithuania	1.6	0.3	-1.1	1.2	2.7	-1.1	0.5	2.3	3.0	3.1	2.4	2.2	3.0
Hungary	9.1	5.2	4.7	6.8	3.5	6.8	7.4	7.0	5.9	3.5	3.6	3.5	3.2
Malta	2.5	2.6	1.9	2.7	2.5	2.5	3.3	3.0	2.2	2.3	2.2	2.1	3.6
Poland	5.3	1.9	0.7	3.6	2.2	1.8	3.4	4.7	4.5	3.6	2.2	1.7	1.2
Slovenia	8.6	7.5	5.7	3.7	2.5	3.7	3.8	3.6	3.5	2.8	2.2	2.3	2.6
Slovakia	7.2	3.5	8.4	7.5	2.8	8.2	8.1	7.4	6.2	2.8	2.6	2.2	3.7
EU-10 weighted average	5.7	2.6	1.9	4.1	2.5	3.0	4.0	4.8	4.5	3.2	2.4	2.2	2.2
EU-10 unweighted average	4.9	3.1	2.9	3.9	3.1	3.0	3.9	4.5	4.2	3.3	2.9	2.8	3.3
EU-10 standard deviation	2.7	2.0	2.9	2.2	1.5	2.8	2.5	2.0	1.7	1.5	1.5	1.6	1.7
euro area	2.4	2.3	2.1	2.1	2.2	1.7	2.3	2.3	2.3	2.0	2.0	2.3	2.3

Source: Eurostat.

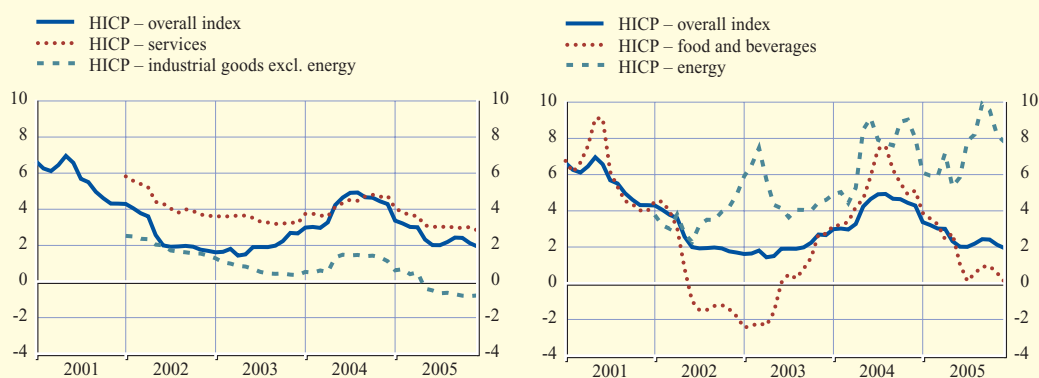
Inflation developments over the past three years, however, varied considerably across countries. Some that had relatively high inflation rates in 2003, namely Cyprus, Hungary, Slovenia and Slovakia, reduced their inflation rates significantly by end-2005. Other countries, such as the Czech Republic and Poland, which started from lower levels of inflation in 2003, experienced a pick-up in their inflation rates in 2004, followed by a return to more moderate levels in the course of 2005. In the Baltic States, inflation increased considerably in 2004 from mostly a relatively low level or, in the case of Lithuania, even a negative level, and continued to rise further in 2005 as a whole. In general, inflation developments in the new Member States tend to be rather volatile, due to, inter alia, the high share of food prices in the HICP consumption basket, a high oil dependency ratio and rather frequent changes in indirect taxes and administered prices.

Recent inflation developments in the new Member States have been driven mainly by three factors: EU accession, the surge in international oil prices and cyclical developments. In the context of EU accession, a number of indirect taxes and administered prices had to be increased in some countries due to EU single market requirements. In the run-up to these adjustments, a higher demand for a number of products was observed, which had a further upward effect on prices. Moreover, food prices accelerated strongly in the first half of 2004 in the new Member States (see chart). This was largely due to their participation in the Common Agricultural Policy from May 2005 onwards. The elimination of remaining trade barriers and the lower price level of many food products in these countries resulted in increased demand for intra-EU exports of foodstuffs, which also contributed to higher prices.

In addition, the surge in oil prices since mid-2003 has triggered some upward pressure on inflation in all new Member States, reflecting the fact that the weight of energy-related items in their HICP basket is relatively high (on average around 14.7% in 2005 compared with 8.5% in the euro area). Yet its inflationary impact varied considerably across the new Member States, partly due to differences in the consumption pattern and the energy intensity of production, as well as the existence of long-term contracts for energy delivery in some countries. Moreover,

HICP inflation and selected sub-indices in the new Member States

(monthly data; annual percentage changes)



Sources: Eurostat and ECB calculations.

Note: All indices are weighted. Data for the weighted HICP sub-aggregates for services, industrial goods excluding energy and energy are only available from January 2002.

the pass-through of higher oil prices to HICP inflation was, in some countries, cushioned by reduced excise duties and the pricing policy of regulatory bodies responsible for energy prices for consumers (electricity, gas).

Cyclical developments have also played an important role in explaining inflation developments in the new Member States in recent years. Strong demand growth, closing negative output gaps and accelerating wage growth have contributed to inflationary pressures in a number of countries.

All these upward pressures on inflation were counterbalanced partly by some downward price effects, which related in particular to increased import competition in industrial goods (such as clothing and household appliances) and regulatory reforms in network industries (such as telecommunications), the latter being also partly related to EU accession. Moreover, in some countries, namely the Czech Republic, Hungary, Poland and Slovakia, inflationary pressures were partly offset by their currencies appreciating against the euro.

In sum, EU accession-related price effects in conjunction with the strong increase in international energy prices led to a sharp increase in inflation in most of the new Member States in 2004. Developments in 2005 showed that several countries appear to have managed to avoid or limit potential second-round effects from these inflationary shocks. However, caution is warranted in some countries where inflation continued to remain high or rise further in 2005 in order to avoid the emergence of a more protracted period of inflationary pressures.