

- Subsequent to the accession to the European Union (EU) in May 2004, the inflation rates accelerated in all three Baltic States.
- Inflation rates got a boost from the tax changes related to the EU legislation that entered into force.
- Unlike in Estonia, the annual inflation rate continued to accelerate in Latvia and Lithuania also in the second half of 2004, arising from the base effect, stronger inflationary expectations related to the EU accession and a rise in administrative prices.

DIFFERENCES IN CONSUMER PRICE CHANGES IN THE BALTIC STATES SUBSEQUENT TO THE ACCESSION TO THE EUROPEAN UNION

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Immediately after the accession to the European Union on 1 May 2004 the consumer price growth rate accelerated in most of the new Member States. The Baltic States are often viewed as a uniform area with similar economic developments, but the inflationary developments in Estonia, Latvia and Lithuania have been different (both before and after the EU accession). The following is a short overview of the differences between the consumer price developments in the Baltic States after the accession to the EU.

■ Changes in the Inflation Rates in the Baltic States ■

Subsequent to the accession to the EU in May 2004 the growth rate of consumer prices accelerated in all the Baltic States. Both the annual and monthly growth rate¹ of the harmonised index of consumer prices (HICP) accelerated most in Estonia, i.e. by 2.2 and 1.2 percentage points (pp), respectively (see Figures 1 and 2).

¹ Annual growth rate: growth compared to the same month last year; monthly growth rate: growth compared to the previous month.

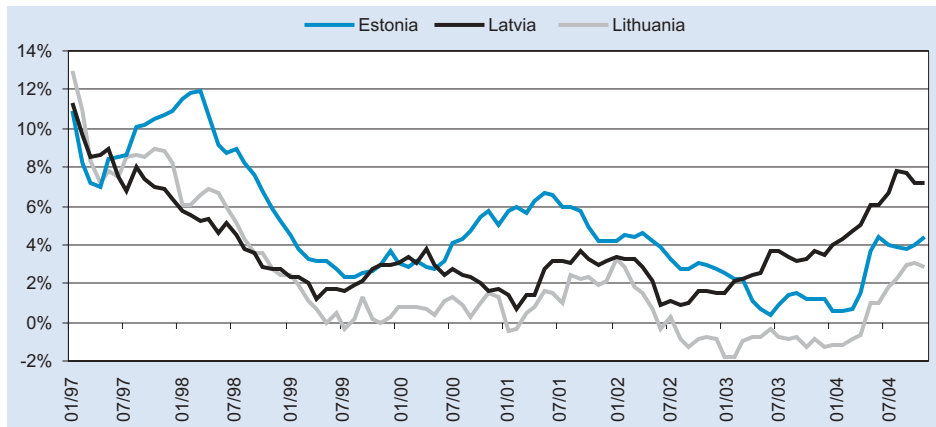


Figure 1. Annual growth rate of HICP in the Baltic States

Source: Eurostat

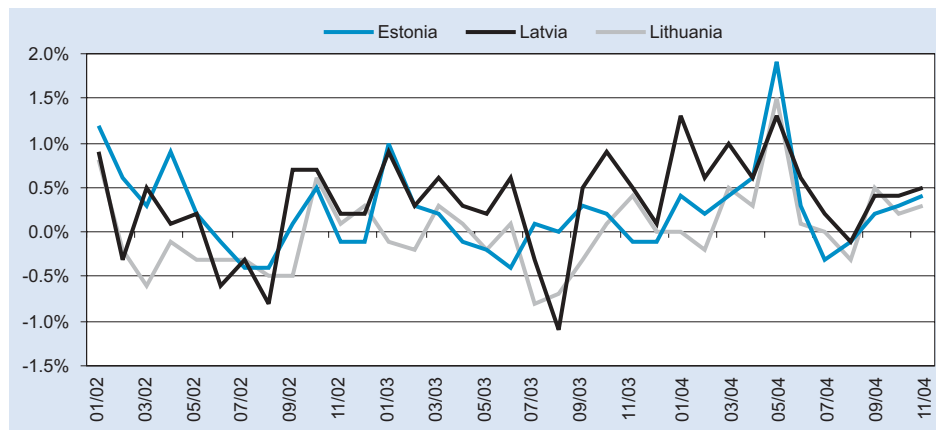


Figure 2. Monthly growth rate of HICP in the Baltic States

Source: Eurostat

In Estonia, the price growth of May 2004 was clearly of one-off character; meanwhile the increase in Latvia's consumer prices after the accession to the EU could be treated as a continuing trend of accelerating price growth that started in 2002. After the accession to the EU, the deflationary period in Lithuania that had continued for years finally came to an end, followed by a comparatively fast inflation.

In Estonia, the rate of inflation started to subside as of July 2004 following a surge after the EU accession.² In Latvia and Lithuania, consumer prices continued rapid

² In November 2004 (to some extent also in October) the annual rise in consumer prices accelerated because of the base effect, reflecting the decline in food prices over the last months of 2003. Inflationary pressures in Estonia did not intensify in the second half of 2004.

increase also in the second half of 2004, which indicates the effects of other types of inflationary pressures besides the impact arising from the EU accession.

The faster growth in Latvian and Lithuanian consumer price indices in the second half of 2004 was partly caused by the base effect of 2003. In Latvia, the base effect had a particularly strong impact in August, when the annual growth rate stood at 1.1 percentage point, despite the month-on-month decline in consumer prices.³

■ Reasons for the Acceleration of Inflation ■

In most of the new EU Member States, including **all three Baltic States, several tax changes entered into force as of the moment of accession on 1 May 2004, thus raising the prices of goods and services.** The gradual harmonisation of national legislation with the EU legislation, including harmonisation of VAT and excise duty rates, has lasted for several years in the newly acceded countries. As for some tax rates (e.g. tobacco products in Estonia), a transitional period has been agreed on, which covers a certain number of years after the accession to the EU. The enforcement of legislative changes that would raise the level of prices has been spread across a longer time period so as to avoid a sharp one-off price increase.

However, the enactment of several tax changes, including the common rates of customs duty applied on the external EU border, still accumulated in May 2004. The extent of the acceleration in the inflation rate arising from tax changes varied across countries, depending on the legislation harmonisation schedules in these countries.

In Estonia, after the accession to the EU the inflation rate was above all accelerated by a rise in **fuel excise duties** and a subsequent growth in motor fuel prices. The imposition of duties on the imports of sugar from third countries had a significant impact too.

In Latvia, faster growth in the consumer price index was also mainly due to a rise in **fuel excise duties**; unlike in Estonia the inflation rate was additionally boosted by **increased VAT rates on pharmaceuticals**. The tobacco excise duty was raised in Latvia at the beginning of 2004.

In Lithuania, the inflation growth rate was also increased by the **rise in fuel and tobacco excise duties**. The biggest impact on Lithuania's inflation rate in May 2004 came from increased food and transport services prices, and similarly to Latvia, also the prices of **health care services and pharmaceuticals** went up considerably.

The prices for food increased faster in Estonia and Lithuania immediately after the accession to the EU; in Latvia, on the other hand, food prices increased more in the second half of 2004 (see Figure 3). In Latvia, food prices grew also most compared to Estonia and Lithuania.

³ Arising from seasonal factors, the consumer prices in Latvia fell in August 2004 less than in previous years (The Bank of Latvia. Monetary Bulletin 8/2004).

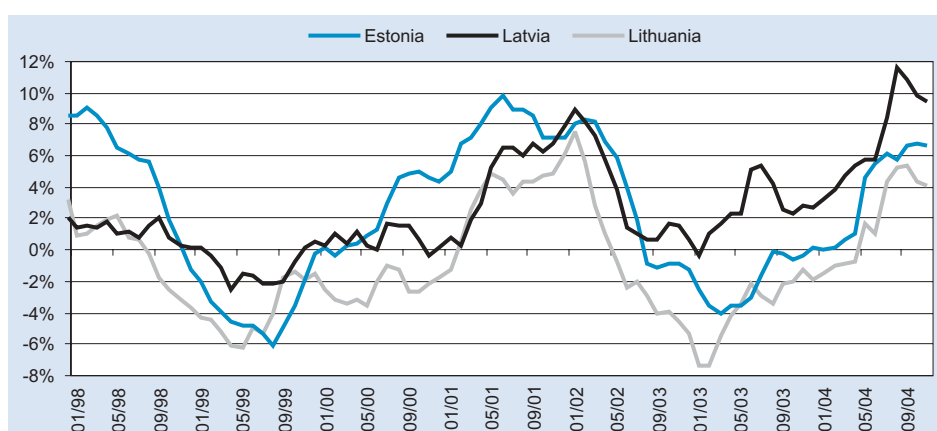


Figure 3. Annual growth in the prices for food and non-alcoholic beverages in the Baltic States

Source: Eurostat

While in Estonia food prices mainly increased due to a rise in the prices of sugar, in Latvia the rise in the prices of dairy products played a significant role due to higher purchase prices. According to the price information of the Estonian Institute of Economic Research, the annual growth in milk purchase prices in Latvia peaked in the summer of 2004. In Estonia, milk purchase prices are higher than in Latvia and Lithuania.

The impact the rise in the food price level had on the overall increase in the harmonised index of consumer prices was somewhat stronger in Latvia and Lithuania than in Estonia due to the larger share of food among the HICP components (see Table 1). In Estonia the share of transport prices in the HICP basket is bigger than in Latvia and Lithuania, which is why equivalent annual rise in fuel prices has

Table 1. Weights of HICP components in Estonia, Latvia and Lithuania in 2004 (%)

HICP components	Weights of components		
	Estonia	Latvia	Lithuania
Food and non-alcoholic beverages	22.2	28.4	28.9
Alcohol and tobacco	8.0	5.8	8.4
Clothing and footwear	7.4	7.2	7.6
Housing costs	15.1	13.8	13.0
Furnishing	4.1	5.0	5.3
Health care	3.0	3.8	4.4
Transport	13.1	10.6	9.2
Communications	4.9	6.0	4.6
Culture	7.3	6.9	5.7
Education	2.1	1.5	1.3
Hotels and restaurants	6.8	6.5	7.3
Other goods and services	5.9	4.5	4.3
Total	100	100	100

a more extensive impact on the Estonian consumer price index. Regarding motor fuel prices, only the fuel prices for personal transport equipment are distinguished in transport prices, with the share in the HICP transport prices being highest in Lithuania (49%) and lowest in Latvia (34%), while 42% in Estonia.

The structural differences in the HICP basket still had a comparatively small impact on the differences in the annual inflation rate in Estonia, Latvia and Lithuania. The hypothetical year-on-year HICP growth rates in Latvia and Lithuania, measured with the Estonian HICP basket weights, do not differ significantly from the actual annual HICP growth measured with national HICP weights. In August 2004, when Latvia's inflation rate was the fastest over recent years, the hypothetical year-on-year growth in Latvia was just 0.3 pp and in Lithuania only 0.1 pp lower than the actual annual HICP growth (see Figure 4).

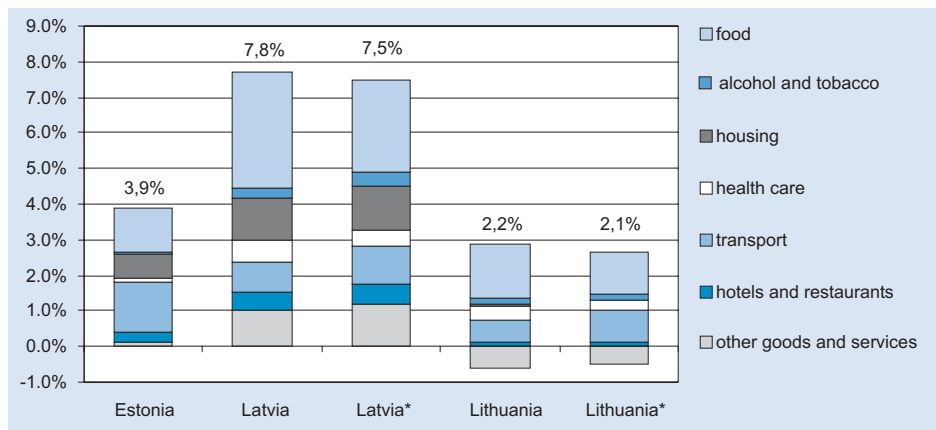


Figure 4. Annual growth in the Estonian, Latvian and Lithuanian HICP by components and according to national and Estonian HICP weights in August 2004⁴

Source: Eurostat

Multiplying the annual growth in the Lithuanian and Latvian HICP components by Estonia's HICP weights, the impact of food and transport prices on Latvia's and Lithuania's inflation would change most. The rise in food prices would have less impact on the HICP and the impact of health care prices in both countries would decline as well. However, the rise in transport prices would have a greater influence both in Latvia and Lithuania.

■ Main Differences in the Inflation Determinants in Estonia and the other Baltic States ■

In Latvia and Lithuania the period of price acceleration following the accession to the EU has lasted longer than in Estonia. Even though precise data about the harmonisation of tax rates

⁴ The hypothetical inflation in Latvia and Lithuania measured with the Estonian HICP weights is marked with an asterisk (*).

in Latvia and Lithuania with the EU legislation are not available, **the effects of tax changes on the inflation rate in Latvia and Lithuania probably accumulated more in 2004 than they did in Estonia.** One of the reasons for Latvia's inflation rate outpacing that of Estonia and Lithuania is also faster growth in food prices compared to the neighbouring countries as well as the considerably greater importance of food in the HICP structure compared to Estonia.

The exchange rates of Estonian and Lithuanian national currencies have been fixed against the euro while Latvian national currency has been pegged to the SDR, i.e. a basket of currencies including the euro as well as the US dollar and to a lesser extent also other currencies. Latvia's inflation rate has accelerated in line with the rise in the euro exchange rate against the US dollar since the end of 2002 (see Figure 5).

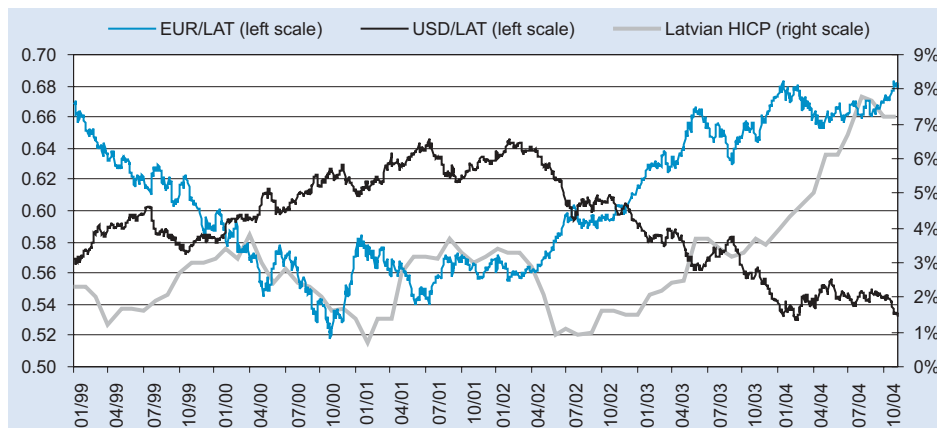


Figure 5. Exchange rate of the Latvian lat against the euro and the US dollar and the annual HICP growth in Latvia

Sources: Eurostat, Bank of Latvia

However, according to the estimates of the Bank of Latvia, the impact of the currency exchange rates on Latvian economy remains small.⁵ A significant source of inflationary pressure both in Latvia and Lithuania are the stronger inflationary expectations of the consumers, which are related to the EU accession. In Estonia, no rise in inflationary expectations has been observed in 2004.

The central bank of Latvia also mentions the **strong and accelerating growth in domestic demand in Latvia** as one of the factors contributing to a faster inflation rate, which has also increased the prices for travel, financing and personal services.⁶ Unlike in the neighbouring countries, besides the factors related to the accession to the EU, Latvia's inflation rate in 2004 was boosted by the increase in electricity prices, the growth in insurance tariffs in the first half of the year and the hike in gas tariffs in July.⁷

⁵ Bank of Latvia. Monetary Bulletin 5/2004.

⁶ Bank of Latvia. Monetary Bulletin 3/2004, 8/2004.

⁷ Bank of Latvia. Monetary Bulletin 7/2004.

■ Summary ■

After the accession to the EU the annual growth in consumer prices increased both in Estonia, Latvia and Lithuania. **In Estonia**, the increase in the inflation rate was brought about by **one-off factors** arising from the changes in tax rates related to the EU accession, and the annual growth rate of inflation stabilised fast in the summer months of 2004. In **Latvia and Lithuania**, the inflation rate was faster also in the second half of 2004 partly because of the **base effect**, but also due to the **probably more extensive accumulation of the effect arising from harmonising the VAT and excise duty rates with the EU legislation in the year 2004**.

The differences in the HICP structure had little impact on the differences between the annual inflation rates. In Latvia, the annual inflation rate was somewhat increased by the **larger weight of food in the HICP structure**. **The impact of the differences in the exchange rate mechanism on the divergence of Estonia's and Latvia's inflation also remained modest**, since according to the estimates of Latvia's central bank, the rise in the euro exchange rate against the US dollar affected inflation only slightly. In Latvia, much more relevance is given to the growing inflationary expectations associated with the accession to the EU. In Estonia, domestic inflationary pressures did not intensify in the second half of 2004.