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What is behind the real appreciation of the accession countries' currencies? An investigation of the PPI-based real exchange rate

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Abstract

In the paper, we calculate real equilibrium exchange rates (EER) for EU accession countries and compare these with the actual exchange rate movements since the mid-1990s. The real equilibrium exchange rates are derived from models of macroeconomic balance and tested for econometrically. It is found that productivity increases can be regarded as one source of the observed PPI-based real appreciation of the accession countries' currencies. These productivity gains experienced in the process of economic catch-up imply an increased capacity to produce high-quality export goods and are a key driving force of exports. To a large extent real appreciation can, therefore, be viewed as an equilibrium phenomenon.

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1. Introduction

The development of the real exchange rates of the EU accession countries has attracted considerable attention. One reason is that in the near future it will become necessary to

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judge the appropriateness of the nominal exchange rate—and correspondingly of the real exchange rate position—when fixing the exchange rate within ERM II. The convergence criterion for the exchange rate requires that the nominal exchange rate be stable during the 2 years preceding entry to the Euro Area, i.e., exchange rate movements within ERM II do not exceed the permitted fluctuation band. As most accession countries have moved from fixed exchange rates to a more flexible exchange rate determination during the transition period, participation in ERM II means a return to an exchange rate peg. Furthermore, exchange-rate stabilisation will have to be achieved with unrestricted capital flows and, in all likelihood, current account deficits on the part of the accession countries.

A correctly chosen exchange rate is a prerequisite for avoiding the threat of a loss of competitiveness that could hinder real growth as well as convergence and result in a damaging exit from the peg. This task is complicated by the fact that the currencies of the accession countries have been on a path of real appreciation since the initial macroeconomic stabilisation was achieved, i.e., for a number of years now. In standard macroeconomic models an appreciating real exchange rate is seen as a loss of competitiveness that will cause current account deficits to grow, and may require future adjustment processes that reverse the initial appreciation. However, for the transition countries it is often argued that real appreciation might be the result of rising prices in the service sector during the catch-up process (Balassa–Samuelson effect), in which case it would not affect their international competitiveness. Yet, it is not only the CPI-based real exchange rate that has shown a downward trend, but also the real exchange rate based on producer price indices (PPI), which does not include price changes in the service sector.¹ This phenomenon has rarely been addressed and econometrically tested in discussions of the transition countries' real exchange rates. This is all the more surprising as PPI-based appreciation is consistent with the existing current account deficits. The current account deficits were made possible by considerable privatisation proceeds, direct investment and, after the liberalisation of capital account transactions, short-term capital inflows attracted by interest rate differentials. In fact, capital inflows have, at times, been so large that they collided with the implicit or explicit exchange rate target, threatened disinflation policies due to foreign exchange intervention and increased the vulnerabilities to sudden or large withdrawals. PPI-based appreciation implies that the existing current account deficits could become even larger relative to GDP in the years to come. However, so far the current account deficits have not continuously increased despite the real appreciation of the national currencies (Graphs 1–3).

Instead, both exports and imports have been rising in nominal and in real terms, and in some countries the current account deficits have even declined. Although trade integration is surely one reason for this trend in exports and imports, this cannot fully explain why exports increased markedly (in some countries almost as much as imports) in spite of the real appreciation of the currency measured in PPI terms. It follows that there must be a factor of at least equal importance that is causing exports to rise *ceteris paribus* faster than imports. In our opinion this factor—resulting from catch-up growth—is an increase in the capacity to produce goods of higher quality and technological content, i.e., to generate higher export proceeds. The systemic change and the liberalisation of trade and capital

¹ Producer price indices (PPI) are usually calculated for industrial products.

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