

СТРУЧНИ РАДОВИ
WORKING PAPERS

2012



Народна банка Србије
National Bank of Serbia

Радови у оквиру ове серије представљају резултат тренутних истраживања аутора и објављују се у циљу иницирања дискусије и добијања корисних сугестија за даљи рад аутора.

Working Papers describe research in progress by the author(s) and are published to encourage discussion and suggestions for future work.

СТРУЧНИ РАДОВИ
WORKING PAPER SERIES 22

Оцена утицаја Балаша-Самјуелсоновог ефекта у
земљама централне и источне Европе:
ревидирана анализа на бази тестова
коинтеграције панела

Мирјана Милетић

Estimating the Impact of the Balassa-Samuelson
Effect in Central and Eastern European Countries:
A Revised Analysis of Panel Data Cointegration
Tests

Mirjana Miletic

За ставове изнете у радовима у оквиру ове серије одговоран је аутор и ставови не представљају нужно званичан став Народне банке Србије.

The views expressed in the papers constituting this series are those of the author, and do not necessarily represent the official view of the National Bank of Serbia.

Сектор за монетарне анализе и статистику

НАРОДНА БАНКА СРБИЈЕ

Београд, Краља Петра 12,

Тел.: (+381 11) 3027 100

Београд, Немањина 17,

Тел.: (+381 11) 333 8000

www.nbs.rs

Monetary analyses and statistics department

THE NATIONAL BANK OF SERBIA

Belgrade, 12 Kralja Petra Street,

Telephone: (+381 11) 3027 100

Belgrade, 17 Nemanjina Street,

Telephone: (+381 11) 333 8000

www.nbs.rs

Оцена утицаја Балаша-Самјуелсоновог ефекта у земљама централне и источне Европе: ревидирана анализа на бази тестова коинтеграције панела

Мирјана Милетић

Апстракт: Овај рад има за циљ да оцени допринос Балаша-Самјуелсоновог ефекта инфлацији и реалној апрецијацији у земљама централне и источне Европе на бази података за панел од девет земаља за период од средине деведесетих година до трећег тромесечја 2010. године. Анализа је спроведена ради добијања одговора на питање у којој мери је глобална економска криза утицала на успоравање степена реалне конвергенције поменутих земаља.

Балаша-Самјуелсонов ефекат у просеку објашњава мање од 1.5 процентних поена разлике у инфлацији у земљама централне и источне Европе у односу на евро зону и око 1 процентни поен домаће инфлације. Добијени резултати оцењивања нису се значајније променили у зависности од спецификације модела као и коришћеног метода оцењивања. Већина резултата упућује на то да се утицај Балаша-Самјуелсоновог ефекта није значајније променио током кризе, иако је оцена нешто нижа него за период пре 2004. године.

Кључне речи: Баумол-Бовенов ефекат, Балаша-Самјуелсонов ефекат, реална апрецијација, инфлација
JEL Code: C23, E31, F31, F36, O11, O40, O52

Estimating the Impact of the Balassa-Samuelson Effect in Central and Eastern European Countries: A Revised Analysis of Panel Data Cointegration Tests

Mirjana Miletic

Abstract: This paper aims to reassess the contribution of the Balassa-Samuelson effect to the inflation and real exchange rate appreciation using panel data for nine CEECs covering the period ranging from the mid-1990s to the third quarter of 2010. The main idea of this analysis is to answer the question of whether the Global Economic Crisis had a significant impact on the efforts of CEECs to stay on the path of real convergence.

The Balassa-Samuelson effect explains less than 1.5 percentage points on average of inflation differential relative to the euro area and around 1 percentage point of the total domestic inflation. The results are robust across the model specification and estimation method. Most of the results point out that the Balassa-Samuelson effect has not changed considerably during the crisis even though it is lower compared to that in the earlier stage of transition (for the period up to 2004).

Key words: Baumol-Bowen effect, Balassa-Samuelson effect, real appreciation, inflation
JEL Code: C23, E31, F31, F36, O11, O40, O52

Special thanks are due to profesor Zorica Mladenovic for her generous help in the estimation and interpretation of the results obtained, as well as for the given comments and suggestions. I would also like to thank Pedroni and Haurling for sharing their RATS and Matlab code, respectively and colleagues from the National Bank of Serbia Olivera Jovanovic and Ljubica Trajcev for help in adjusting those codes.

Contents

Non-Technical summary.....	1
1. Introduction.....	3
2. Analytical Framework	5
2.1 The Theoretical Concept of the Balassa-Samuelson Effect.....	5
2.2 Estimation Techniques	8
3. Empirical Investigation.....	10
3.1 Review of the Empirical Studies	10
3.2 Data, Sources, and Definitions	13
3.3 Empirical results.....	14
3.3.1 Testing the Baumol-Bowen effect.....	15
3.3.2 Testing the Balassa-Samuelson Effect	21
4. Concluding Remarks.....	25
5. References.....	27

Non-Technical summary

This paper focuses on the importance of the Baumol-Bowen (BB) and Balassa-Samuelson (BS) effects in nine Central and Eastern European countries (Bulgaria, Croatia, Czech Republic, Hungary, Macedonia, Poland, Romania, Slovenia, and Slovakia). The BB and BS hypothesis provides a useful framework for explaining the cross-sector (tradable and non-tradable sector) and cross-country inflation differentials. The key idea behind the theory is that, in a given economy, a higher productivity growth in the tradable sector relative to the non-tradable pushes up wages in both sectors. This in turn increases the ratio of non-tradable to tradable prices. This framework in the literature is known as Baumol-Bowen effect. The Balassa-Samuelson effect is an international extension of the Baumol-Bowen model, which describes the cross-country consequences of relative productivity dynamics, expressed in terms of inflation differentials and the real exchange rate. If the productivity growth in one country is higher than in another, the overall inflation will be higher in the former, and the real exchange rate is likely to appreciate in the long run.

Empirical evidence on the BB and BS effect in Central and Eastern European (CEE) countries is mixed. Even though authors use various econometric methods, as well as different indicators of cross-sector productivity and inflation, and distinguish the tradable and non-tradable sectors in different ways, their results most often confirm the presence of the BS effect. The first round of studies, conducted from the late 1990s to the early 2000s, suggested that the BS effect is one of the major determinants of the high inflation in CEE countries. In contrast to previously mentioned studies that estimated a very strong contribution of the BS effect in CEE countries, a large group of studies found that the BS effect is rather modest and that it is not sufficient to explain the observable real exchange appreciation in CEE countries.

To address these issues, we empirically test for the BB effect in three steps: 1. between productivity and real wages in the tradable sector, 2. between real wages in the tradable and the non-tradable sector and, 3. between difference in productivity in tradable and non-tradable sectors and the difference between non-tradable and tradable inflation. Furthermore, following the recent crisis, we also assess whether the Global Economic Crisis had a significant impact on the importance of the effect in CEE countries.

We test for the BS effect in two steps by: 1) testing the existence of the long-run relationship between the real exchange rate and the difference in cross-sector

productivity in CEE countries relative to the euro area and, 2) estimating the average contribution of the productivity differential to the inflation differential.

Empirical findings suggest that approximately one percentage point of inflation could be explained by the BB effect. The results also show that the BB effect has the highest contribution in Slovenia and Slovakia, and the lowest contribution in Bulgaria, where the difference in productivity between the tradable and the non-tradable sector is also the lowest. On average, the BS effect's contribution to the inflation differential and real appreciation is less than 1.5 percentage points. The results of this analysis seem to suggest that the BS effect is stronger in economies with a stronger convergence process.

The main policy implication of empirical results is that the BB effect is not a determining factor of the ability of CEE countries to satisfy the Maastricht inflation criteria. Most of the results point out that the BS effect was not noticeably changed during the crisis, even though it was lower compared to that in the earlier stage of transition (for the period up to 2004). Thus, it can be anticipated that the slowdown of the convergence process due to a crisis will not be an obstacle for investors and that these countries will again begin the race to converge.

The analysis suggests that the Baumol-Bowen and the Balassa-Samuelson effects still play a role in inflation and the real exchange rate, and are likely to remain on the agenda of both policy and research for a while but not as significantly as in the earlier stage of transition. In principle, we should expect the Balassa-Samuelson effect to persist for the entirety of the convergence period, which should continue for at least the ensuing decade, before and after the adoption of the euro; however, the size of the effect will depend on the speed of the convergence process.

1. Introduction

Since the beginning of the transition process, most Central and Eastern European countries (*CEECs*) have experienced relatively high inflation rates and real appreciation of their currencies. The *Balassa-Samuelson* theory (*the BS effect*) provides a supply-side explanation for the relative price of tradables and non-tradables in an economy and is one of the prime explanations for the continuous real appreciation of *CEECs* against their western counterparts. The key idea behind the *BS* theory is that, in a given economy, a higher productivity growth in the tradable sector than that in the non-tradable pushes up wages in all sectors. This in turn increases the relative prices of non-tradable goods and increases the ratio of non-tradable to tradable prices. If the productivity growth in one country is higher than in another, the overall inflation will be higher in the former, and the real exchange rate is likely to appreciate in the long run.

Analyzing the extent to which inflation is caused by the *BS* effect is important for at least three reasons.

Firstly, the inflation arising from the *BS* effect does not cause a loss of competitiveness. That is, although the prices of non-traded goods rise relative to the prices of traded goods, the tradable sector does not become less profitable due to its higher rate of productivity growth. Since this component of real appreciation occurs with no loss to competitiveness, there is no risk to external accounts.

Secondly, this issue has implications on the conduct of monetary policy. Rising inflation or continuous real exchange appreciation resulting from a higher productivity growth does not require the same monetary policy response as when it is not productivity driven, and therefore, the monetary authority should consider the strength of the *BS* effect in setting its inflation target. Rising relative prices of non-traded goods would need the prices in the traded goods sector to drop in order to achieve the inflation target. Disinflation in the tradable goods sector requires the exchange rate to appreciate over time, and the central bank has to keep the interest rate high to offset the inflation caused by the non-traded goods sector.

Thirdly, as a consequence of the EU accession of most *CEECs*, the *BS* theory has become a popular framework for assessing the feasibility of meeting the Maastricht criteria [see Cristian Paun 2010]. A problem might arise in the new European Union member countries if the inflation and exchange rate criteria are impossible to achieve in the presence of the *BS* effect.

There would be a risk of sacrificing real convergence for nominal because a monetary tightening, which might be necessary for the inflation or exchange rate to meet the Maastricht criteria, could suppress real growth.

The *BS* effect contains at least two propositions. First, it implies that the relative price of non-traded goods in each country should reflect the relative productivity of labor in the traded and non-traded goods sector. Second, it assumes that purchasing power parity (*PPP*) holds for traded goods.

The first generation of studies, from the late 1990s to the early 2000s, suggested that the *BS* effect is one of the major determinants of the high inflation in *CEECs*. Here, the contribution of the *BS* effect to inflation usually constitutes up to 3 percentage points.

A second generation of studies pointed out that the *BS* effect may not be as important for the new EU members as had previously been suggested. These studies usually concluded that the observed inflation and real exchange appreciation are explained by the *BS* effect only in small part.

The main difference between these two waves of studies is the finding of the latter that the relative *PPP* does not hold in the tradable sector. This does not imply that the *BS* effect has a small impact on overall real exchange rate movements because the *BS* effect is supposed to explain the difference between the overall inflation-deflated and real exchange rate based on prices of tradable goods. Hence, if the share of market-based non-tradable prices in the *CPI* is large enough, the *BS* effect can explain a large part of the overall exchange rate movements. Therefore, another reason for the limited explanation of the real exchange rate appreciation by the *BS* model is the small ratio of market-based non-tradable goods in the *CPI* [see Balasz Egert, Laszlo Halpern, and Ronald MacDonald 2006]. One more reason why earlier studies had obtained higher estimates of the *BS* effect is that the estimates were produced with time series models; in the newer literature, panel models were used. Also, many earlier studies, such as Fabrizio Corricelli and Bostjan Jazbec (2001), Laszlo Halpern and Charles Wyplosz (2001), and Marco Cipriani (2001) had failed to consider the impact of productivity differentials on inflation relative to the euro area, focusing only on the Baumol-Bowen (*BB* effect) effect, which was usually stronger [as noted in Dubravko Mihaljek and Marc Klau 2004, p. 11].

Only a handful studies [for instance, Balasz Egert 2005; Paun 2010; Maria Machova 2008; Mihaljek and Klau 2008] analyzed the importance of the *BS* effect in countries other than the eight EU member states mentioned, such as Southeastern European countries. Also, in the literature little attention has been paid to testing the importance of this factor in the period after 2004 [see Mihaljek and Klau 2008]. This motivates us to reassess the contribution of the *BS* effect to inflation and real exchange rate appreciation using panel data for nine *CEECs* covering the period from the mid-1990s to the third quarter of 2010, and to contribute to the empirical literature on this topic. The analyzed period is relevant because, with the exception of Macedonia, all sampled countries have since joined the European Union. Assessing the size of the *BS* effect for these countries, as well as for countries that have entered the exchange rate mechanism ERM II, is therefore of particular interest. The key idea

of this analysis is to answer the question of whether the Global Economic Crisis had a significant impact on the importance of the *BS* effect in *CEECs*.

Besides the size and the up-to-dateness of the sample, several features related to the estimation procedure distinguish this study from others. For testing the cointegration between more than two variables, we used the panel cointegration test proposed by Gangadharrao Maddala and Shaoven Wu (1999), which enables identifying the number of cointegrated vectors. For the robustness check of empirical results, we used several panel estimation techniques: fully modified *OLS* (*FMOLS*), dynamic *OLS* (*DOLS*), pooled mean group (*PMGE*), and mean group (*MGE*).

The remainder of the paper is organized as follows: The next two chapters lay out the analytical and empirical framework used in the paper. In the second chapter, a theoretical exposition of the *BB* and *BS* effects is presented, as well as the econometric methodology used for estimating and testing those hypotheses. The third chapter covers a review of the empirical literature, a brief discussion of the data sources, definitions of the variables included in the empirical analysis, and the empirical results of the *BB* and *BS* effect. In the fourth chapter, the main conclusions of the empirical analysis and the policy implications of these results are presented.

2. Analytical Framework

2.1 The Theoretical Concept of the Balassa-Samuelson Effect

Consider the case of a small open economy that produces traded (T) and non-traded goods (N), assuming a CoBB-Douglas production function with labor (L) and capital (K) as production factors:

$$Y^T = A^T K^{T(1-\theta^T)} L^{T\theta^T}, Y^N = A^N K^{N(1-\theta^N)} L^{N\theta^N}, \quad (1)$$

where θ^T and θ^N refer to elasticity of output with respect to labor in the traded and the non-traded goods sector, respectively, and A is the total factor productivity. Competition in the labor market assures that the wages in the two sectors will be equal to the marginal product of labor:

$$W^T = P^T \frac{\partial Y^T}{\partial L^T} = P^T \theta^T A^T \left(\frac{K^T}{L^T} \right)^{1-\theta^T}, W^N = P^N \frac{\partial Y^N}{\partial L^N} = P^N \theta^N A^N \left(\frac{K^N}{L^N} \right)^{1-\theta^N}, \quad (2)$$

where W^T and W^N represent wages in the traded and the non-traded goods sector, respectively.

Assuming that the wages are the same in the traded and the non-traded sector, the price ratio of tradable to non-tradable goods is defined by:

$$R = \frac{P^N}{P^T} = \frac{\theta^T A^T \left(\frac{K^T}{L^T} \right)^{1-\theta^T}}{\theta^N A^N \left(\frac{K^N}{L^N} \right)^{1-\theta^N}} = \frac{\theta^T \frac{Y^T}{L^T}}{\theta^N \frac{Y^N}{L^N}} \quad (3)$$

If the degree of labor and capital intensity is the same in the traded and the non-traded sectors, i.e., $\theta^T = \theta^N$, after log-differencing transformation, the previous equation obtains the following form:

$$\Delta \log R = \Delta \log \frac{Y^T}{L^T} - \Delta \log \frac{Y^N}{L^N} = \Delta a^T - \Delta a^N, \quad (4)$$

where Δa^T and Δa^N are the labor productivity rates in the traded and the non-traded

sectors, respectively and $a^T = \log \frac{Y^T}{L^T}$, $a^N = \log \frac{Y^N}{L^N}$.

The last equation shows that the growth of the relative prices is equal to the difference between the average labor productivity growth in the traded and non-traded goods sector. Assuming that the productivity growth is higher in the traded goods sector, this equation suggests that the relative productivity growth determines the prices in the non-traded goods sector and, consequently, headlines inflation. Given that, firms in the non-traded goods sector will increase the prices of their goods to retain profitability. Consequently, the relative prices will increase, $\log R = \log P^N - \log P^T$. This effect is known in the literature as the domestic *Balassa-Samuelson* or *Baumol-Bowen* effect.

If the wage rates in the traded and non-traded goods sectors are allowed to differ, the equation that describes the behavior of the price of non-traded goods relative to that of traded goods after log-differencing becomes:

$$\Delta \log R = \Delta \log \frac{Y^T}{L^T} - \Delta \log \frac{Y^N}{L^N} - \Delta \log \frac{W^T}{W^N} \quad (5)$$

If the wages in the traded goods sector grow faster relative to the wages in the non-traded goods sector, this will offset the relative increase in productivity and lead to lower growth of the relative prices of non-traded goods.

Furthermore, the inflation rate could be expressed as a weighted average of traded and non-traded inflation:

$$\pi^{CPI} = \alpha \pi^N + (1 - \alpha) \pi^T = \pi^T + \alpha \Delta \log R, \quad (6)$$

where α is the share of non-traded goods in the consumer basket.

The expression $\alpha\Delta\log R$, which is defined as the relative productivity growth, represents the contribution of the *BS* effect to domestic inflation.

The *BS* effect can also help explain the inflation differential between two countries:

$$\pi^{CPI} - \pi^{CPIF} = \Delta\log S + \alpha\Delta\log R - \alpha^F\Delta\log R^F, \quad (7)$$

where S is the nominal exchange rate [see Cipriani 2001, p. 6].

Next, it can be seen how the relative productivity difference contributes to real appreciation, assuming that the productivity growth is faster in the home country than in a foreign country [see Jesus Crespo-Cuaresma, Jarko Fidrmuc, and Ronald MacDonald 2003, p. 140].

Replacing equation (6) in the real exchange rate change equation ($r = s + \pi^{CPIF} - \pi^{CPI}$) and assuming the same share of non-tradable goods in the consumer basket in the domestic and the foreign country, $\alpha = \alpha^F$, where r is the real exchange rate change, and $s = \Delta\log S$ gives:

$$r = s + \pi^{FT} - \pi^T + \alpha\left[(\pi^T - \pi^N) - (\pi^{FT} - \pi^{FN})\right]. \quad (8)$$

Because the prices in the domestic traded goods sector and abroad are equal, if they are expressed in the same currency, the real exchange rate change is determined by the changes in relative prices in the non-traded goods sector, or

$$r = -\alpha\left[(\pi^N - \pi^T) - (\pi^{FN} - \pi^{FT})\right]. \quad (9)$$

Based on equation (4), and replacing it in equation (9), the real exchange rate change can be computed as

$$r = -\alpha\left[(\Delta a^T - \Delta a^N) - (\Delta a^{FT} - \Delta a^{FN})\right]. \quad (10)$$

The last equation shows that a faster growth in relative productivity in the tradable sector than in the non-tradable sector results in real appreciation of the domestic currency.

2.2 Estimation Techniques

All empirical tests for verification of the *BS* hypothesis were conducted in a heterogenous dynamic panel framework using Peter Pedroni (1997) and Johansen-type panel cointegration tests, as proposed by Maddala and Wu (1999). Although we presented all seven Pedroni tests, the decision relating to cointegration was made due to group *ADF*, panel *ADF*, and panel ρ statistics, that is, if at least one of those statistics confirms it. Specifically, we had in mind the results of Pedroni (2004) that showed that for values of *T* larger than 100, all seven statistics that were proposed do fairly well and are quite stable, while for smaller samples (*T* is lower than 20), group *ADF* statistics are the most powerful, followed by panel *ADF* and panel ρ statistics. We chose to use the non-weighted instead of the weighted panel Pedroni statistics due to their better performance in small samples.

However, Pedroni type cointegration tests do not allow testing of the number of cointegrated vectors between more than two variables. Therefore, for testing cointegration between more than two variables, we used the Johansen panel cointegration test proposed by Maddala and Wu (1999), which enables identifying the number of cointegrated vectors. This test is actually based on combining the *p* values from the Johansen trace and the maximum eigenvalues statistics for each panel member. Therefore, in this work we used Pedroni tests for testing cointegration between two variables and the Johansen panel cointegration test for more than two variables.

The long-run relationship between relevant macroeconomic variables was estimated by fully modified *OLS* (*FMOLS*), dynamic *OLS* (*DOLS*), pooled mean group (*PMGE*), and mean group (*MGE*) estimator techniques.

FMOLS estimation allows for serial correlation in the residuals and for endogeneity of regressors in the cointegrating regression, and results in an asymptotically efficient estimation of the cointegrating vector. The pooled *FMOLS* coefficients can be computed in two different ways: within a dimension and between dimensions. Here, we will present only the between-dimension group *FMOLS* estimator of the mean panel cointegration parameter, which is given as:

$$\beta_{GFM}^* = \frac{1}{n} \sum_{i=1}^n \left(\sum_{t=1}^T (x_{it} - \bar{x}_i)^2 \right)^{-1} \left(\sum_{t=1}^T (x_{it} - \bar{x}_i) y_{it}^* - T \hat{\gamma}_i \right), \quad (11)$$

$$y_{it}^* = y_{it} - \frac{\hat{L}_{21i}}{\hat{L}_{22i}} \Delta x_{it}, \quad \hat{\gamma}_i = \hat{\Gamma}_{21i} + \hat{\Omega}_{21i}^0 - \frac{\hat{L}_{21i}}{\hat{L}_{22i}} \left(\hat{\Gamma}_{22i} + \hat{\Omega}_{21i}^0 \right),$$

where x_{it} is the m -dimensional vector of explanation variables, and \hat{L}_i is the lower triangular decomposition of a consistent estimator of the idiosyncratic asymptotic covariance matrix $\Omega_i = \Omega_i^0 + \Gamma_i - \Gamma_i'$, with \hat{L}_i normalized such that $\hat{L}_{22i} = \hat{\Omega}_{i22}^{-1/2}$, and the serial correlation adjustment parameter $\hat{\gamma}_i$ is given by
$$\hat{\gamma}_i = \hat{\Gamma}_{21i} + \hat{\Omega}_{21i}^0 - \frac{\hat{L}_{21i}}{\hat{L}_{22i}} \left(\hat{\Gamma}_{22i} + \hat{\Omega}_{22i}^0 \right)$$
. The *FMOLS* estimator is distributed normally [see Pedroni 1997, p. 103].

The expression following the summation over i is identical to the conventional time series *FMOLS* estimator, and the between-dimension estimator can be constructed simply as the average *FMOLS* estimator for each panel member. Likewise, the associated t statistics for the between-dimension estimator can be constructed as:

$$\bar{t}_{\beta^*_{GFM}} = \frac{1}{\sqrt{n}} \sum_{i=1}^n \hat{L}_{11i}^{-2} \left(\sum_{t=1}^T (x_{it} - \bar{x}_i)^2 \right)^{-1/2} \left(\sum_{t=1}^T (x_{it} - \bar{x}_i) y_{it}^* - T \hat{\gamma}_i \right) \rightarrow N(0,1) \quad (12)$$

Contrary to *FMOLS*, the *DOLS* estimator recommended by Chihwa Kao and Min-Hsien Chiang (2000) employs a parametric correction for endogeneity achieved by augmenting the regression with leads and lags of the first difference of x_{it} , as below:

$$y_{it} = \alpha_i + \beta_i x_{it} + \sum_{k=-K}^K \gamma_{ik} \Delta x_{it-k} + \mu_{it} \quad Z, \quad (13)$$

where the estimated coefficient β is given by:

$$\beta_{DOLS}^* = \frac{1}{n} \sum_{i=1}^n \left(\sum_{t=1}^T z_{it} z_{it}' \right)^{-1} \left(\sum_{t=1}^T z_{it} y_{it}^* \right), \quad (14)$$

where $z_{it} = \left(x_{it} - \bar{x}_i, \Delta x_{it-K}, \dots, \Delta x_{it+K} \right)$ is the vector of regressors.

The pooled mean group (*PMGE*) estimator involves pooling and averaging, and allows the intercepts, short-run coefficients, and error variances to differ freely across groups, but the long-run coefficients are constructed to be the same. The *PGME* was introduced by Hashem Pesaran, Yongcheol Shin, and Ronald Smith (1998), who proposed estimating the following autoregressive distributed lag (*ARDL*) model of orders $l1$ and $l2$:

$$\Delta y_i = \beta_0 + \rho \left(y_{i,-1} - \sum_{i=1}^n \beta_n X_i \right) + \sum_{j=1}^{l1} \lambda_j^* \Delta y_{i,-j} + \sum_{i=1}^n \sum_{j=0}^{l2} \Delta X_{i,-j} \delta_{ij}^* + \varepsilon_i \quad (15)$$

The dependent variable in the first differences is regressed on the lagged values of dependent and independent variables in the levels and first differences. The long-run coefficients, β , are defined to be the same across countries (the *MGE* method allows differences in long-run coefficients across individuals).

The error correction term obtained from the pooled mean group estimator is used as a test of cointegration. A negative and statistically significant error correction term, ρ , confirms the presence of a long-run relationship between y_{it} and x_{it} . The equation is estimated using the maximum likelihood procedure.

The conclusion relating to the empirical testing of the *BB* and the *BS* effect has been based mostly on *FMOLS* and *DOLS* method estimates, while *PMGE* and *MGE* techniques have been used for robustness checking.

3. Empirical Investigation

3.1 Review of the Empirical Studies

The *BS* effect in *CEECs* has been empirically tested in numerous works. Even though authors use various econometric methods, as well as different indicators of relative prices and relative productivity, and distinguish the tradable and non-tradable sectors in different ways, their results most often confirm the presence of the *BS* effect [see Josip Funda, Gorana Lukinic, and Igor Ljubaj 2007, p. 326].

It is impossible to address all the papers on the subject in this article considering their large number. Therefore, we will summarize the results and the techniques applied in the most cited selected recent empirical studies of the *BS* effect in *CEECs* [for further review, see Jose Garcia-Solanes 2008; Fritz Breuss 2003; Virginie Coudert 2004; etc.].

The first round of studies, conducted from the late 1990s to the early 2000s, suggested that the *BS* effect is one of the major determinants of the high inflation in *CEECs* [see Andras Simon and Mihaly A. Kovacs 1998; Philipp Rother 2000; Halpern and Wyplosz 2001; Adriana Loschova 2003; etc.]. Here the contribution of the *BS* effect to the real appreciation in a number of *CEECs* constitutes up to 3 percent points per annum.

For instance, Halpern and Wyplosz (2001) estimated the *BS* effect in *CEECs* using fixed and random effects, and ordinary least square and generalized least square methods for unbalanced panels. Their results confirmed the presence of the *BS* effect of a magnitude of 3 percent points per annum.

Lojschova (2003) tested the *BS* effect using time series and panel estimation techniques for Slovakia, Czech Republic, Poland, and Hungary during the period between 1995 and 2002. According to these results, the individual country estimates of the *BS* effect are approximately 2.5% per annum, while when using panel models, this effect is smaller and ranges from 0.8% in Hungary to 2% in Poland. Furthermore, Lojschova (2003) tested an extended version of the *BB* effect with wages as an additional explanatory variable, but the estimated coefficients of productivity were not changed significantly compared to the model that did not take wages into account.

In contrast to previously mentioned studies that estimated a very strong contribution of the *BS* effect in *CEECs*, a large group of studies [for instance, Mark De Broeck and Torsten Slok 2001; Cipriani 2001; Mihaljek and Klau 2004; Monika Blaszkiewicz et al. 2004; Martin Wagner and Jaroslava Hlaskova 2004; Egert 2005; etc.] found that the *BS* effect is rather modest and that it is not sufficient to explain the *oBS*ervable real exchange appreciation in *CEECs*. The contribution of the *BS* effect to real appreciation in those studies ranged from 0% to 1.5%.

For example, De Broeck and Slok (2001) regressed the real exchange rate on the productivity differential between sectors for a range of *CEECs*; depending on the specifications used, the elasticities obtained varied between 0.2 and 0.6. Using a similar regression based on panel data, Corricelli and Jazbec (2001) obtained an elasticity of roughly 0.5.

Cipriani (2001) focused on structural inflation rather than real exchange rate in his study on the *BS* effect. He used a panel of ten *CEECs* between 1995 and 1999. According to him, the *BS* effect is relatively weak due to the relatively small share of non-tradables in the consumer price index and the pronounced growth of productivity in the tradable and non-tradable sectors. Cipriani (2001) argued that around 0.7 percentage point of *oBS*erved inflation could be explained by the productivity growth differentials between the tradable and non-tradable sectors.

Balasz Egert, Imed Drine, and Christophe Rault (2002) estimated the magnitude of the *BS* effect for nine *CEECs* using panel cointegration techniques. According to these authors, even in countries where the increase in relative productivity in the tradable sector is very sharp, such as Poland, the impact on relative prices compared to Germany remains moderate, between 1.2% and 2.4% per annum. Even though they detected that the productivity growth in the tradable sector is likely to bring about a non-tradable inflation, they argued that this depends on the composition of the consumer price index basket, as well as on the share of regulated prices.

Using time series models, Mihaljek and Klau (2004) found that the *BS* effect in six *CEECs* explained, on average, only between 0.2 and 2.0 percentage points of annual inflation differentials vis-a-vis the euro area. They also argued that, as the pace of catching up decelerates, these effects are likely to decrease and hence should not become a determining factor of the ability of these countries to satisfy the Maastricht inflation criterion. An updated analysis of Mihaljek and Klau (2008) confirmed the

presence of the *BS* effects in *CEECs* countries in the period since the mid-1990s through the first quarter of 2008. On average, *BS* effects explain around 24% of inflation differentials vis-a-vis the euro area (about 1.2 percentage points on average) and 84% of the domestic relative price differentials between non-tradables and tradables, or about 16% of overall domestic *CPI* inflation (about 1.1 percentage points on average).

Blaszkiewicz et al. (2004) conducted an empirical analysis for an unbalanced panel of nine *CEECs* in the period between 1995 and 2003. *FMOLS* and *PMGE* panel estimations pointed to a well-behaved and statistically significant *BB* effect, while there was less evidence in favor of the *BS* effect. They argued that their estimates of the contribution of the *BS* effect to inflation (below 2 percent points per annum) and to real appreciation (below 3 percent points) must be interpreted with caution because productivity indicators are subject to short-run fluctuations, which may lead to a negligible or even negative *BS* effect.

Wagner and Hlauskova (2004) conducted an assessment of the *BS* effect in eight *CEECs* in the period between 1993 and 2000. They investigated a variety of specifications of extended models (non-homogeneity of wages, deviations from *PPP* in tradables, and including demand-side variables to explain inflation differentials). Evidence of the *BS* effect was found, but it was relatively small (around half a percent per annum) and not sufficient to explain the inflation differentials between *CEECs* and euro area countries.

Following the work of Wagner and Hlauskova (2004), Machova (2008) quantified the *BB* and the *BS* effect for 24 European countries divided into Western nations, *CEECs*, and Delta (Romania and Bulgaria) countries. Using a panel data method in the period between 1996 and 2005, Machova (2008) obtained the *BB* effect quantified as percent of inflation per annum and the *BS* effect as less than half a percent per annum.

Paun (2010) tested the *BS* effect for the period between 1999 and 2007 based on Euclidian distances between real and nominal convergence, which were previously estimated for each of the *CEECs*. The author found unconvincing evidence of the *BS* effect in most *CEECs*; clear evidence of the *BS* effect was found only in Lithuania.

The literature has also identified some puzzles related to the operation of the *BS* effect [see Balasz Egert and Jiri Podpiera 2008; Kosta Josifidis, Emilija Beker, and Novica Supic 2008; Balasz Egert 2010]. Some of those studies, which found the *BS* effect to be modest, provide an explanation for the tendency toward real exchange rate appreciation in *CEECs* using complementary determinants such as demand-side factors, as well as structural transformation and institutional factors [see Jose Garcia-Solanes 2008, p. 29-30]. Demand-side factors have been proxied by different types of variables, such as real interest rate differential [for instance, Lojschova 2003; Christoph Fischer 2004], real income per capita and government spending as a percentage of *GDP* [for instance, Rother 2000; Olga Arratibel, Diego Rodriguez-

Palenzuela, and Christian Thimann 2002], the budgetary deficit [Arratibel, Rodríguez-Palenzuela, and Thimann 2002], the share of private consumption over *GDP* [Coricelli and Jazbec 2004; Fischer 2004], and total consumption [Wagner and Hlouskova 2004], among others.

For instance, Arratibel, Rodríguez-Palenzuela, and Thimann (2002) highlighted the importance of nominal wage growth and fiscal policy, as well as the impact of liberalization-oriented reforms on lowering inflation in the non-tradable sector. According to these empirical findings, the productivity growth in the tradable sector does not seem to have been a significant variable explaining the inflation dynamics in the non-tradable goods sector in *CEECs*.

Fischer (2004) developed and tested a model that included an investment demand channel. The *BS* effect still exists and, additionally, the domestic demand affects the price of non-tradables and thereby the real exchange rate. The model predicts that capital demand is negatively dependent on the price of non-tradables and on the interest rates.

Jose Garcia-Solanes, Francisco Sancho-Portero, and Fernando Torrejon-Flores (2007) found that increases in the demand for differentiated domestic tradables, which are steered by higher economic growth and improvements in the quality of these goods, introduce an upward bias in the prices of tradables in these countries, leading to trend appreciations in the real exchange rate of tradable goods.

Michael Brandmeier (2006) found that the impact of productivity on inflation differences is probably superimposed by the growth rate of the monetary stock or by influences from the demand side of the economy.

Different explanations of the *PPP* puzzle are addressed in the literature; some of the most important are problems with precise sector division, incomplete substitutability of tradables in the euro area and *CEECs*, the existence of the non-tradables processing component introducing frictions to the international arbitrage, and imperfect competition [see Blaszkievich et al. 2004; Jose Garcia-Solanes and Fernando Torrejon-Flores 2009]. The results of most empirical studies [see Matthew Canzoneri, Robert Cumby, and Behzad Diba 1999; Egert, Drine, and Rault 2002; Lukasz Rawdanowicz 2004; Blaszkievich et al. 2004; Mirjana Palic 2009; etc.] show that the stronger version of *PPP* is not satisfied in *CEECs*.

3.2 Data, Sources, and Definitions

The data set used in this study consists of average labor productivity data, real wages, relative prices, and real exchange rates. The panel data cover 9 *CEECs* (Bulgaria, Croatia, Czech Republic, Hungary, Macedonia, Poland, Romania,

Slovenia, and Slovakia). All series are transformed into natural logarithms. The empirical testing of the *BB* hypothesis is conducted using quarterly data covering the period from 1995 to 2007; for the *BS* hypothesis, the data cover the period from 1997 to 2007. The first years of transition are eliminated from this analysis due to the fact that during this period, price and productivity developments were driven more by initial reforms than by the *BS* effect. The *BB* effect and the *BS* effect are tested to extend the analysis to the period of the Global Economic Crisis (covering the period from 1995/1997 to the third quarter of 2010). This panel is unbalanced due to the fact that, in the interim, Slovenia and Slovakia became EMU members.

The national account data, wages, and employment data are obtained from Eurostat and national statistical offices, while nominal and real exchange rate data, as well as *CPI* and *PPI* indices, are taken from International Financial Statistics.

One crucial issue in constructing productivity and relative price variables is how to define the tradable and non-tradable sectors. No consensus has been reached in the literature on this issue, but most empirical studies refer to industry, or industry and agriculture, as the tradable goods sector. Egert, Drine, and Rault (2002) highlighted that their results are affected by the way sectors are classified, particularly whether or not agriculture is considered as part of the tradable sector.

Average labor productivity, which is a proxy for average total productivity, is computed using the above classification as a basis and by dividing the sectoral value added to the corresponding number of employees. Considering only the number of full-time employees instead of the total number could change the *BS* and the *BB* effect on inflation and real appreciation, especially in countries with a higher share of agriculture in total gross value. However, those series were not been publicly available for all analyzed countries.

Sectoral productivities serve as a basis for calculating relative productivities, *PRI* (if only industry is considered as tradable) and *PRIA* (if both industry and agriculture are considered as tradable). All other sectors, excluding administration, are considered as non-tradable. Relative productivity differential is defined as the ratio of relative productivities in *CEECs* and Euro Area 12.

Following the empirical work of Blaszkiewicz et al. (2004), and Egert, Drine, and Rault (2002), we use two types of proxies as a measure of relative prices. Firstly, relative price (*RPI*) is defined as the ratio of the corresponding sectoral *GDP* deflators. The prices of non-tradable goods are given by the *GDP* deflator for services, while the prices of tradable goods are given by the *GDP* deflators for industry. Secondly, the ratio of services in consumer price index and producer price index is used as a proxy for relative prices (*RP2*).

The real exchange rate is calculated using the *GDP* deflator in the services sector (*REG*). Other measures, such as prices in the tradable sector as well as *CPI*, could be used as the deflator for the real exchange rate

3.3 Empirical results

Prior to testing the long-run relationship between different macroeconomic variables, we applied panel unit root tests by Kyung So Im, Hashem Pesaran, and Yongcheol Shin (2003), and In Choi (2001) to test for non-stationarity, a necessary condition for cointegration. The tests were performed on levels and first differences, but for practical reasons, only the results of those carried out on levels are presented (*Table 1*). The presence of a unit root for all indicators in the specification with constant was confirmed by both tests, while for the specification with trend, the applied tests for some indicators pointed to the rejection of the null hypothesis of non-stationarity. The applied tests are inconclusive, but the presence of a unit root could not be strongly rejected in any case and leads us to conclude that the variables are non-stationary in levels.

Table 1: Results of panel unit root tests

Period: 1995:1 to 2007:4	Model without trend		Model with trend	
	<i>IPS statistics</i>	<i>Choi statistics</i>	<i>IPS statistics</i>	<i>Choi statistics</i>
<i>PRI</i>	0.0149 (0.5059)	0.14212 (0.5565)	-1,26124 (0.1036)	-1,10721 (0.1341)
<i>PRIA</i>	-1.78737 (0.0369*)	-0.78556 (0.2161)	-3.29065 (0.0005***)	-2.48909 (0.0064***)
<i>RPI</i>	-0.86268 (0.1942)	-0.70875 (0.2392)	-1.11965 (0.1314)	-0.94719 (0.1718)
<i>RP2</i>	-1.21851 (0.1115)	-0.86197 (0.1944)	-0.72732 (0.2335)	-0.17849 (0.4292)
<i>RERG</i>	-1.49179 (0.0679)*	-1.27415 (0.1013)	-3.25913 (0.0006***)	-3.04510 (0.0012***)

Note: In all tables, * refers to statistical significance at 10%, ** refers to statistical significance at 5%, and *** refers to statistical significance at 1%. The data source for all tables is the author's calculations. The number of lags included in the model is chosen according to the Schwarz information criterion. P values are given in parentheses.

3.3.1 Testing the Baumol-Bowen effect

Empirical testing of the *BB* effect was conducted in three steps: between productivity and real wages in the tradable sector, between real wages in the tradable and the non-tradable sector, and between relative productivity and prices.

The long-run relationship between productivity (PR_T) and real wages ($RWAG_T$) in the tradable sector (industry) is a necessary condition to confirm that the *BS* effect is one of the most important factors of real appreciation. The cointegration relationship is confirmed by most Pedroni tests for the model with constant and trend, and partly for a model with individual intercept only (Table 2).

Table 2: Pedroni panel cointegration test for $RWAG_T^{CEEC}$ and PR_T^{CEEC}

Period: 1995:1 to 2007:4	Model with individual intercepts		Model with individual intercepts and individual trends	
	statistics	p value	statistics	p value
Panel v	2.2152	0.0343**	2.089	0.0449**
Panel rho	-0.0836	0.3975	1.283	0.1751
Panel PP	-2.5939	0.0138**	-3.196	0.0024***
Panel ADF	-1.8801	0.0681*	-1.721	0.0908*
Group rho	1.0253	0.2359	1.4588	0.1377
Group PP	-2.3768	0.0237**	-4.3959	0.0000***
Group ADF	-1.1674	0.2018	-3.4635	0.0010***

Note: In all tables, * refers to statistical significance at 10%, ** refers to statistical significance at 5%, and *** refers to statistical significance at 1%. The data source for all tables is the author's calculations. The number of lags included in the model is chosen according to the Schwarz information criterion.

Table 3: Estimation of cointegration relationship between real wages and productivity

Period: 1995:1 to 2007:4	Method		
Explanatory variables	<i>FMOLS</i>	<i>MGE</i>	<i>PMGE</i>
PR_T^{CEEC}	0.43 (-46,28)***	0.466 (2.56)***	0.656 (12.21)***
Error correction term	-	-0.184 (-4.71)***	-0.08 (-3.95)***
Specification		ARDL (1,1)	ARDL (1,1)

Note: Test statistics are given in parentheses.

The *FMOLS* and *PMGE* results are broadly in line with the findings from the cointegration analysis, but the estimated coefficient of real wages elasticity is far from that found in the analysis. This suggests that a significant influence of the *BS* effect on inflation and real appreciation is unlikely.

These findings are in line with the results of Egert's (2005) analysis for the panel composed of Bulgaria, Croatia, Turkey, Romania, Russia, and Ukraine, which revealed a real wage elasticity ranging from 0.5 to 0.8.

In the next step, the cointegration between the wages in the traded goods sector and in the non-traded goods sector was tested (Table 4). The wages in construction, transport, trade, education, and health weighted by the number of employees in those sectors were used as a proxy for non-tradable sector wages.

In contrast to the long-run relationship between relative productivity and wages, the long-run relationship between wages in the tradable and in the non-tradable goods sector is less obvious and, more importantly, not confirmed by the tests that we consider as the most appropriate (group *ADF*, panel *ADF*, and panel ρ). This result is of great importance for the empirical testing of the *BB* effect: if the assumption of wage equalization is not satisfied, the difference in wages between the tradable and

the non-tradable sector should be included as a factor in domestic inflation, in addition to relative productivity.

Table 4: Panel cointegration test for $RWAG_N^{CEEC}$ and $RWAG_T^{CEEC}$

Period: 1995:1 to 2007:4	Model with individual intercepts		Model with individual intercepts and individual trends	
	statistics	p value	statistics	p value
Panel v	-0.1782	0.3927	5.569	0.000***
Panel rho	-1.5669	0.1169	-0.7233	0.3071
Panel PP	-8.9428	0.0000***	-3.2607	0.0020***
Panel ADF	-0.3438	0.3761	2.2137	0.034**
Group rho	1.4982	0.1299	2.7682	0.009***
Group PP	-3.2080	0.0023***	1.3286	0.1650
Group ADF	0.0314	0.3987	0.5576	0.3415

The cointegration between relative prices and relative productivity is strongly confirmed by group *ADF* and panel *ADF* statistics for relative prices and relative productivity if *GDP* deflators are used as a proxy for relative prices (Table 5).

Table 5: Panel cointegration test for *RPI* and *PRI*

Period: 1995:1 to 2007:4	Model with individual intercepts		Model with individual intercepts and individual trends	
	statistics	p value	statistics	p value
Panel v	2.3779	0.0236**	-0.1053	0.3967
Panel rho	-1.1151	0.2142	0.1922	0.3916
Panel PP	-6.4806	0.0000***	-6.4767	0.0000***
Panel ADF	-5.6037	0.0000***	-3.9147	0.0002***
Group rho	0.2682	0.3848	1.6862	0.0963*
Group PP	-5.2885	0.0000***	-4.3691	0.0000***
Group ADF	-7.2672	0.0000***	-5.2826	0.0000***

The estimation of price elasticity from the relative productivity growth is done by the *FMOLS* method. The results of the *FMOLS* method (Table 6) suggest that a faster productivity growth by 1% in the tradable goods sector causes increased prices in non-tradable goods, measured by *GDP* deflators as 0.4 percentage points. The estimation of this effect for separate countries ranges from 0.1 for Bulgaria to 0.65 for Slovakia. All estimated coefficients are positive and statistically significant.

Table 6: FMOLS estimation of cointegration between RPI and PRI

Country	Period: 1995:1 to 2007:4		Period: 1995:1 to 2010:3	
	Coefficient	Test statistics	Coefficient	Test statistics
Czech Republic	0.49	-8.33***	0.33	-12.93***
Croatia	0.14	-11.58***	0.16	-13.89***
Poland	0.52	-5.66***	0.46	-11.58***
Hungary	0.53	-2.90***	0.12	-13.65***
Slovenia	0.56	-13.12***	0.61	-13.92***
Slovakia	0.65	-5.73***	0.46	-16.88***
Macedonia	0.20	-27.05***	0.20	-30.08***
Bulgaria	0.07	-6.87***	-0.35	-8.00***
Average without time effects	0.40	-28.73***	0.25	-42.76***

Note: The t statistics are for the null hypothesis that the estimated coefficient is equal to one. Therefore, for coefficients that are positive but lower than one, the test statistics are negative.

Including the period of the Global Economic Crisis in the analysis does not significantly change the estimation of the *BB* effect, although the estimated the contribution of productivity differential to relative prices is lower. The Crisis significantly changed only the contribution of productivity differential to the relative prices of non-tradable goods in Bulgaria, whose coefficient became negative.

For the sake of robustness checking, we estimated the same relationship by *MGE*, *PMGE*, and *DOLS* methods (Table 7). In line with the *FMOLS* results, *MGE*, *PMGE* and *DOLS* pointed to a well-behaved and statistically significant *BB* effect. In all three models, the panel long-run coefficients are positive and statistically significant. The elasticity obtained by *MGE* is similar to that obtained by *FMOLS*, while the elasticity obtained from the *PMGE* and *DOLS* method is slightly higher. This confirms the robustness of the obtained results related to the *BB* effect.

Table 7: MGE, PMGE, and DOLS estimators of the cointegration vector between relative prices (RPI) and relative productivity (PRI)

Period: 1995:1 to 2007:4	Method		
Explanatory variables	<i>MGE</i>	<i>PMGE</i>	<i>DOLS</i>
<i>PRI</i>	0.25 (2.32)**	0.42 (14.09)***	0.40 (22.85)***
Error correction term	-0.51 (-8.75)***	-0.36 (-5.16)***	
Specification	ARDL (1,1)	ARDL (1,1)	DOLS (2,2)

The estimates are not significantly changed when both industry and agriculture are included in the tradable sector (the results of this analysis have not been presented separately). Presuming that the share of agriculture in total gross value is low, except in Slovakia, Romania, and Bulgaria, the inclusion of agriculture does not change the

estimation of the impact of productivity on non-tradable prices. The coefficient is negative only in Bulgaria, which has very low productivity in agriculture. The estimates obtained by *MGE*, *PMGE*, and *DFE* methods are, as in a previous case, very close to the *FMOLS* estimates.

The results of the *FMOLS* method suggest that 1% faster productivity in the tradable sector compared to the non-tradable sector causes an approximately 0.5% increase in relative prices measured by the ratio of services in *CPI* and *PPI* (Table 8). This effect is smaller than most previous studies suggest [for instance, Egert, Drine, and Rault (2002); Mihaljek and Klau (2008)].

When the ratio of services in the *CPI* and *PPI* indices is used as a proxy for relative prices, the estimated coefficient for each particular country except Croatia is very close to that obtained using *GDP* deflators. The average cointegration coefficient is higher because Bulgaria, Romania, and Macedonia are excluded from the analysis. One possible explanation for this difference in Croatia is inappropriate classification of the tradable and non-tradable sectors due to the high share of tourism in overall exports.

As in the previous case, the average cointegration coefficient is slightly lower when the period of the Global Economic Crisis is included in the analysis.

Table 8: *FMOLS* estimation of the cointegration coefficient between *RP2* and *PRI*

	Period: 1995:1 to 2007:4		Period: 1995:1 to 2010:3	
Country	Coefficient	Test statistics	Coefficient	Test statistics
Czech Republic	0.25	-7.58***	0.39	-10.45***
Croatia	0.86	-0.89	0.73	-2.64**
Poland	0.41	-2.91***	0.30	-9.51***
Hungary	0.59	-2.70***	0.44	-12.98***
Slovenia	0.42	-5.31***	0.42	-5.31***
Slovakia	0.55	-9.08***	0.44	-14.05***
Average	0.51	-11.62***	0.46	-22.91***

Note: A panel of six countries is used (excluding Romania, Bulgaria, and Macedonia). Two lags for kernel estimators are used, but the different specification does not alter the estimation. The t statistics are for the null hypothesis that the estimated coefficient is equal to one. Therefore, for coefficients that are positive but lower than one, the test statistics are negative.

To find out the contribution of the *BB* effect to domestic inflation according to equation (5), we multiplied the share of non-tradable goods and services in the *CPI* by the estimated coefficient of elasticity, which was previously multiplied by the historical average of the domestic productivity differential.

Table 9: Estimates of the Baumol-Bowen effect (covering the period 1995:1 to 2010:3)

Country	Average inflation	Baumol-Bowen effect (RPI, PRI)	Baumol-Bowen effect (RP2, PRIA)
Czech Republic	3.5	0.742395	0.877376
Croatia	3.3	0.42204	1.925555
Poland	5.4	1.037801	0.676827
Hungary	8.0	0.188119	0.689769
Slovenia	5.5	1.490649	1.026348
Slovakia	5.8	1.207362	1.154868
Macedonia	1.9	0.564531
Bulgaria	35.8	-0.2169
Average	8.7	0.5879	1.081735

These findings suggest that approximately one percentage point of inflation (for *RP2* measure) and 0.6 p.p. (for *RPI* measure) could be explained by the *BB* effect. These results related to the average *BB* effect are consistent with the findings of Mihaljek and Klau (2008), and Machova (2008), while the individual country estimates are different. The results show that the *BB* effect has the highest contribution in Slovenia, Slovakia, and Croatia (measured by *RP2*), and the lowest contribution in Bulgaria. For instance, according to Machova (2008), the *BB* effect ranges from 0.15% for Bulgaria to 2.5% for Slovakia. The contribution of the *BB* effect in Mihaljek and Klau (2008) is negative for Hungary and positive but very low for Bulgaria; for the Czech Republic and Slovenia, it is much higher than in our analysis.

The main policy implication of these results is that the *BB* effect is not a determining factor of the ability of *CEECs* to satisfy the Maastricht inflation criteria. Taking into account that Slovenia and Slovakia have already satisfied those criteria and become members of the EMU, it is unlikely that other countries would not be able to do the same.

In line with equation (5), the standard version of the *BB* effect could be extended to an alternative specification that captures the fact that the assumption of wage equalization is not necessarily satisfied due to differences in skills and human capital. Therefore, we could relax the assumption of wage equalization and test the extended version of the *BB* effect, including wage differential as an additional factor in the increase in relative prices [as was done by Lojscova 2003; Wagner and Hlouskova 2004; Machova 2008]. As the previous analysis has not provided clear evidence that wage equalization happens in *CEECs*, the extended version of the *BB* effect is tested.

Table 10: Johansen panel cointegration test for relative prices, productivity, and wages (covering the period 1995:1 to 2007:4)

Number of vectors	Panel trace statistics	p value	Panel eigenvalue	max	p value
None	41.47	0.0000	41.33		0.0000
At most 1	12.80	0.3838	11.51		0.4856
At most 2	9.258	0.6807	9.258		0.6807

Note: The cointegration vector is estimated under the assumption that the number of lags is 2. A panel of six countries is used (excluding Romania, Bulgaria, and Macedonia).

The Johansen panel cointegration test proposed by Maddala and Wu (1999) commits that relative prices, wages, and productivity differential are cointegrated, but not their regressors (Table 10). With reference to this result, the *FMOLS* method could be used.

As the results in Table 10 show, the coefficient of wage differential has the opposite sign for some countries, while the coefficient of relative productivity is almost unchanged. In line with the results of Lojschova (2003), these findings lead to the conclusion that including wage differential as an additional factor in inflation does not contribute much to the prices of non-traded goods. Contrary to these findings, Machova (2008) found evidence of the importance of adding relative wages in the estimation of the *BB* effect.

Table 11: *FMOLS* estimates of the cointegration vector between relative prices, productivities, and wage differentials

Period: 1995:1 to 2007:4	Explanatory variables			
	$PR_T^{CEEC} - PR_N^{CEEC}$		$WAG_T^{CEEC} - WAG_N^{CEEC}$	
Country	Coefficient	Statistics	Coefficient	Statistics
Czech Republic	0.60	-3.66***	1.28	1.12
Croatia	0.17	-11.65***	-0.86	-2.18**
Poland	-0.06	-8.43***	-1.46	-2.81***
Hungary	0.20	-2.66**	-0.82	-1.49
Slovenia	0.54	-8.80***	0.51	1.08
Slovakia	0.55	-6.92***	-0.12	-0.22
Average	0.33	-17.19***	-0.25	-1.84*

Note: A panel of six countries is used (excluding Romania, Bulgaria, and Macedonia). Two lags for kernel estimators are used, but the different specification does not alter the estimated coefficient. The t statistics are for the null hypothesis that the estimated coefficient is equal to one. Therefore, for coefficients that are positive but lower than one, the test statistics are negative.

3.3.2 Testing the Balassa-Samuelson Effect

Testing the *BS* effect consists of several steps. In the first step, the cointegration between the real exchange rate and the difference in relative productivity in *CEECs*

relative to the euro area (as the main trading partner for most of these countries) is tested.

Most of the implemented panel cointegration tests suggest a long-run relationship between the real exchange rate and the difference in relative productivity in *CEECs* and the euro area (*Table 12*).

Table 12: Panel cointegration test of real exchange rate (RERG) and productivity differential (RPR1)

Period: 1997:1 to 2007:4	Model with individual intercepts		Model with individual intercepts and individual trends	
	Statistics	p value	statistics	p value
Panel v	0.423194	0.3648	1.279142	0.1760
Panel rho	0.537641	0.3453	0.129533	0.3956
Panel PP	-3.952783	0.0002***	-8.391602	0.0000***
Panel ADF	-4.251940	0.0000***	-4.913733	0.0000***
Group rho	1.763114	0.0843*	1.235630	0.1859
Group PP	-2.957042	0.0050***	-7.523959	0.0000***
Group ADF	-1.531205	0.1235	-3.183639	0.0025***

Note: The number of lags differs across the individual members. *RPR1* corresponds to productivity differential *PRI*.

Taking into account that all the necessary conditions are fulfilled, the next step of the analysis is to estimate the average contribution of the productivity differential to the inflation differential. Therefore, we estimate the standard version of the *BS* effect. The standard version of the *BS* effect fully corresponds to testing the cointegration between the real exchange rate and productivity differential.

Table 13: FMOLS estimation of the cointegration vector between RERG and RPR1

Country	Period: 1997:1 to 2007:4		Period: 1997:1 to 2010:3	
	Coefficient	Test statistics	Coefficient	Test statistics
Czech Republic	-1.17	-7.49***	-1.07	-13.85***
Croatia	-0.35	-8.02***	-0.44	-9.55***
Poland	-0.87	-3.34***	-0.52	-6.44***
Hungary	0.69	-0.30	-1.14	-6.53***
Slovenia	-0.64	-20.55***	-0.62	-26.22***
Slovakia	-1.06	-10.23***	-0.79	-37.25***
Macedonia	-0.07	-28.78***	-0.08	-29.65***
Bulgaria	0.24	-4.48***	-1.11	-3.11***
Romania	0.04	-5.60***	-0.03	-5.86***
Average	-0.36	-29.60***	-0.65	-46.16***

Note: The t statistics are for the null hypothesis that the estimated coefficient is equal to one. Therefore, for coefficients that are positive but lower than one, the test statistics are negative.

The results of the *FMOLS* method of estimation shows that in contrast to the *BB* effect, which is confirmed for all *CEECs*, there is less evidence in favor of the *BS* effect. In the case of the *BB* effect, the cointegration tests establish robust long-run relationships, and the estimation techniques produce correctly signed panel

coefficients, which is not the case with the *BS* effect. The estimate of the *BS* effect is slightly changed when we extend the analysis to the period of the Global Economic Crisis: the effect becomes stronger and evident for all countries (*Table 13*). Robert J. Sonora and Josip Tica (2009) reached similar *DOLS* estimates for the same model specification (-0.55).

Table 14: MGE, DOLS, and PMGE estimation of the cointegration vector between RERG and RPR1

Period: 1997:1 to 2007:4	Method		
Explanatory variables	<i>MGE</i>	<i>PMGE</i>	<i>DOLS</i>
<i>RPR1</i>	-0.711 (-6.17)***	-0.734 (-13.67)***	-0.675 (-15.97)***
Error correction term	-0.253 (-3.64)***	-0.226 (-3.31)***
Specification	ARDL (1,1)	ARDL (1,1)	DOLS(1,1)

Note: The test statistics are given in parentheses.

On the other hand, the relationship between the productivity differential and the real exchange rate is weaker when using the *RPR2* productivity measure, which includes agriculture as a tradable sector. The estimated elasticity in this case is -0.33 and has the right sign for all countries except Romania and Bulgaria. Contrary to these findings, Vasile Dedu and Bogdan Dimitrescu (2010), using a time series model for the period between 2002 and 2006, concluded that the *BS* effect in Romania explains, on average, around 0.6 percentage points of the observed inflation differential.

Table 15: FMOLS estimation of the cointegration vector between RERG and RPR2

	Period: 1997:1 to 2007:4		Period: 1997:1 to 2010:3	
Country	Coefficient	Test statistics	Coefficient	Test statistics
Czech Republic	-1.19	-9.07***	-1.14	-14.92***
Croatia	-0.28	-5.68***	-0.29	-6.00***
Poland	-0.72	-3.40***	-0.47	-7.44***
Hungary	-0.94	-3.45***	-0.82	-13.39***
Slovenia	-0.62	-19.82***	-0.62	-24.93***
Slovakia	-0.93	-16.07***	-1.23	-23.00***
Macedonia	-0.14	-38.54***	-0.17	-39.41***
Bulgaria	0.32	-3.42***	1.46	1.01
Romania	0.31	-7.64***	0.36	-3.26***
Average	-0.47	-35.70***	-0.33	-43.78***

Note: The t statistics are for the null hypothesis that the estimated coefficient is equal to one. Therefore, for coefficients that are positive but lower than one, the test statistics are negative.

As previously mentioned, the inability to empirically confirm the stronger version of *PPP* impacts the *BS* effect. The violation of *PPP* suggests including in the test the real exchange rate deflated by tradable prices. For this reason, the cointegration

vector is estimated for prices of tradable goods, productivity differential, and real exchange rate (Table 16). First, however, we have to ensure that there is only one cointegration vector.

Table 16: Johansen panel cointegration test for RERG, RPR2, and tradable goods prices (covering the period 1997:1 to 2007:4)

Number of vectors	Panel statistics	trace p value	Panel eigenvalue	max p value
None	75.97	0.0000	77.23	0.0000
At most 1	18.80	0.1727	15.02	0.3770
At most 2	14.77	0.3943	14.77	0.3943

Table 17: FMOLS and PMGE estimation of the cointegration vector between RERG, tradable goods prices, and RPR2

Period: 1997:1 to 2007:4	Method	
Explanatory variables	FMOLS	PMGE
RPR2	-0.33 (-29.45)***	-0.45 (-3.95)***
PPI – PPI*	0.01 (-0.72)	-0.15 (-1.61)
Error correction term	-0.21 (-4.03)***

Including the tradable goods prices (measured by the differences in PPI between CEECs and Euro Area 12) does not contribute to explaining the real exchange rate by the productivity differential; in the case of PMGE, the value has a sign opposite to the one expected and is not statistically significant.

The contribution of productivity differential to growth of relative prices is obtained as the product of the estimated elasticity coefficient and average productivity differential based on historical trends (Table 18).

Table 18: The Balassa-Samuelson effect (covering the period 1997:1 to 2010:3)

Country	Average annual real appreciation	BS effect (RERG, RPR1)	BS effect (RERG, RPR2)
Czech Republic	3.8	-2.233	-2.379
Croatia	1.4	-1.183	-0.780
Poland	2.5	-0.988	-0.893
Hungary	3.3	-0.858	-0.617
Slovenia	1.0	-1.653	-1.653
Slovakia	5.7	-1.998	-3.110
Macedonia	-2.1	-0.416	-0.883
Bulgaria	7.0	0.345	-0.453
Romania	5.5	-0.067	0.807
Average	3.1	-1.427	-0.724

On average, the contribution of the *BS* effect to the real exchange rate appreciation ranges from 0.7% to 1.5% (depending on the measure of relative productivity used). Taking into account that the average annual real exchange rate appreciation in the analyzed period is 3%, it could be concluded that the *BS* effect is not the most important cause of real appreciation. For instance, these results are similar to those of Mihaljek and Klau (2008), while Machova (2008) reached a lower estimate of the *BS* effect. These findings are in line with those of a number of studies reported in Section 3.1, which also showed that more than the *BS* effect, other factors, such as the process of liberalization and opening of these economies to foreign direct investments, as well as the growth of public expenditure through the aggregate demand channel, contribute to real appreciation in these countries.

The results of this analysis seem to suggest that the *BS* effect is stronger in economies with a stronger convergence process. One of the explanations why the *BS* effect is less evident in Bulgaria, Macedonia, and Romania, which could not be directly explained by productivity growth and the *BS* effect, is the process of price liberalization, which affects the prices of both tradable and non-tradable goods and services. The low share of non-traded goods in the CPI index could be also one explanation. Moreover, what seems to characterize these countries is their fast-growing productivity not only in the tradable goods sector but also in the non-traded goods sector.

4. Concluding Remarks

In this paper we investigated the importance of the *BB* and the *BS* effects in nine *CEECs* in the recent period (from the mid-1990s to the third quarter of 2010). Using panel estimation techniques, we found evidence in favor of the *BB* and the *BS* effects. Panel cointegration tests detected a relationship between productivity and relative prices (the *BB* effect), and between relative productivity differential and real exchange rate vis-à-vis the euro area (the *BS* effect). Similar evidence were found using the *FMOLS*, *DOLS*, *PMGE*, and *MGE* methods.

The econometric analysis shows that the *BB* and the *BS* effects are less evident, particularly in Romania, Bulgaria, and Macedonia. One possible explanation for the limited role of the *BS* effect in overall inflation and real exchange rate appreciation is the failure to achieve some of the most important preconditions (a stronger version of *PPP* holds, real wages are proportionately linked to productivity in the tradable sector, wage equalization).

The findings suggest that approximately one percentage point of inflation could be explained by the *BB* effect. The results also show that the *BB* effect has the highest contribution in Slovenia and Slovakia, and the lowest contribution in

Bulgaria, where the difference in productivity between the tradable and the non-tradable sector is also the lowest. On average, the *BS* effect's contribution to the inflation differential and real appreciation is less than 1.5 percentage points. Based on this result, it could be concluded that the *BS* effect is not the most important cause of the real currency appreciation in *CEECs*.

The *CEECs*' target of adopting the euro, already reached by Slovenia in 2007 and by Slovakia in 2009, has sparked debates about right timing and the pertinence of the Maastricht criteria due to crisis implications. This in turn roused the interest of researchers and policy makers in the dynamics of the *BS* effect. Answering the question whether the *BS* effect has become stronger or weaker during the catching up process as well as during the crisis, this analysis is conducted for the subSample period from 1995 to 2007 and from 1995 to 2010.

Most of the results point out that the *BS* effect was not noticeably changed during the crisis, even though it was lower compared to that in the earlier stage of transition (for the period up to 2004). Thus, it can be anticipated that the slowdown of the convergence process due to a crisis will not be an obstacle for investors and that these countries will again begin the race to catch up.

The analysis suggests that the *BB* and the *BS* effects still play a role in inflation and the real exchange rate, and are likely to remain on the agenda of both policy and research for a while but not as significantly as in the earlier stage of transition. In principle, we should expect the *BS* effect to persist for the entirety of the catching-up period, which should continue for at least the ensuing decade, before and after the adoption of the euro; however, the size of the effect will depend on the speed of the catching-up process.

5. References

- Arratibel, Olga, Diego Rodriguez-Palenzuela, and Christian Thimann.** 2002. "Inflation dynamics and dual inflation in accession countries: a new Keynesian perspective." ECB Working Paper, no. 132.
- Blaszkiewicz, Monika, Przemyslaw Kowalski, Lukasz Radwanowicz, and Przemyslaw Wozniak.** 2004. "Harrod-Balassa-Samuelson effect in selected countries of Central and Eastern Europe." CASE Reports 57.
- Brandmeier, Michael.** 2006. "Reasons for real appreciation in Central Europe." Center for Globalization and Europeanization of the Economy discussion paper 55.
- Breuss, Fritz.** 2003. "Balassa-Samuelson Effects in the CEEC: Are they OBStacles for Joining the EMU?" IEF Working Papers 52.
- Canzoneri, Matthew, Robert Cumby, and Behzad Diba.** 1999. "Relative Labor Productivity and the Real Exchange Rate in the Long Run: Evidence for a Panel of OECD Countries." *Journal of International Economics*, Vol. 47, pp. 245-66.
- Choi, In.** 2001. "Unit Root Tests for Panel Data." *Journal of International Money and Finance*, Vol. 20, pp. 249-272.
- Cipriani, Marco.** 2001. "The Balassa-Samuelson effect in transition economies." <http://home.gwu.edu/~mciprian/Cipriani-BalassaTransition.pdf>.
- Coricelli, Fabrizio and Bostjan Jazbec.** 2001. "Real exchange rate dynamics in transition economies." CEPR Discussion Paper 2869.
- Coudert, Virginie.** 2004. "Measuring the Balassa-Samuelson effect for the Countries of Central and Eastern Europe?" www.banque-france.fr/gb/publications/telechar/.../122etud1.pdf.
- Crespo-Cuaresma, Jesus, Jarko Fidrmuc, and Ronald MacDonald.** 2003. "The Monetary Approach to Exchange Rates: Panel Data Evidence for Selected CEECs." http://www.oenb.at/en/img/fttr_20032_tcm16-1138.pdf
- De Broeck, Mark and Torsten Slok.** 2001. "Interpreting real exchange rate movements in transition countries." IMF Working Paper 01/56.
- Dedu, Vasile and Bogdan Dimitrescu.** 2010. "The Balassa-Samuelson effect in Romania." *Romanian Journal of Economic Forecasting – 4/2010*.
- Egert, Balazs, Imed Drine, and Christophe Rault.** 2002. "On the Balassa-Samuelson effect in the transition process: A panel study." *Economics of transition*, 10: 1-16.
- Egert, Balazs, Imed Drine, Kirsten Lommatzsch, and Christophe Rault.** 2002. "The Balassa-Samuelson effect in Central and Eastern Europe: Myth or reality?" William Davidson Working Paper 483.

- Egert, Balazs.** 2005. "Balassa-Samuelson Meets South Eastern Europe, the CIS and Turkey: A Close Encounter of the Third Kind?" William Davidson Discussion Paper 796.
- Egert, Balasz, Laszlo Halpern, and Ronald MacDonald.** 2006. "Equilibrium exchange rates in transition economies: Taking stock of the issues." *Journal of economic surveys*, vol. 20, no. 2, pages 258-324.
- Egert, Balasz and Jiri Podpiera.** 2008. "Structural inflation and real exchange rate appreciation in Visegrad-4 countries: Balassa-Samuelson or something else?" *CEPR Policy Insight* no. 20, April. www.cepr.org.
- Egert, Balasz.** 2010. "Catching-up and Inflation in Europe: Balassa Samuelson, Engel's Law and Other Culprits." OECD Economics Department Working Papers, No. 792, OECD Publishing. <http://dx.doi.org/10.1787/5kmb1scvdk7d-en>
- Fischer, Christoph.** 2004. "Real Currency appreciation in accession countries: Ballasa-Samuelson and investment demand." *Review of World Economics*, 140 (2), 179-210.
- Funda, Junda, Gorana Lukinic, and Igor Ljubaj.** 2007. "Assessment of the Balassa-Samuelson effect in Croatia." *Financial Theory and Practise*, vol. 31, issue 4.
- Garcia-Solanes, Jose, Francisco Sancho-Portero, and Fernando Torrejon-Flores.** 2007. "Beyond the Balassa-Samuelson effect in some new member states of the European Union." CESifo Working paper 1886.
- Garcia-Solanes, Jose.** 2008. "Real exchange rate appreciation in Central and Eastern European countries: Why the Balassa-Samuelson does not explain the whole story." Fundacion BBVA Working paper.
- Garcia-Solanes, Jose and Fernando Torrejon-Flores.** 2009. "The Balassa-Samuelson hypothesis in developed countries and emerging market economies: different outcomes explained." *Economics*, Open assessment e-journal, Vol. 3.
- Halpern, Laszlo and Charles Wyplosz.** 2001. "Economic transformation and real exchange rates in the 2000s: The Balassa-Samuelson Connection." ECE Discussion paper Series 2001/1.
- Im, Kyung So, Hashem Pesaran, and Yongcheol Shin.** 2003. "Testing for Unit Roots in Heterogeneous Panels." *Journal of Econometrics*, Vol. 115, No. 53-74.
- Josifidis, Kosta, Emilija Beker, and Novica Supic.** 2008. "Real Exchange Rate Appreciation in the Transition Economies." Paper presented at the 12th International Conference on Macroeconomic Analysis and International Finance, Rethymno, Crete.
- Kao, Chihwa and Min-Hsien Chiang.** 2000. "On the Estimation and Inference of Cointegrated Regression in Panel Data." *Advances in Econometrics* 15, 179-222.

- Kovacs, Andras M.** (ed.). 2002. "On the estimated size of the Balassa-Samuelson effect in five Central and Eastern European Countries." NBH Working Paper 2002/5.
- Lojschova, Adriana.** 2003. "Estimating the impact of the Balassa-Samuelson effect in transition economies." <http://www.ihs.ac.at/publications/eco/es-140.pdf>.
- Loko, Boileau and Anita Tuladhar.** 2005. "Labor Productivity and Real Exchange Rate: The Balassa-Samuelson Disconnect in the Former Yugoslav Republic of Macedonia." IMF Working Paper No. 113.
- Machova, Maria.** 2008. "The Balassa-Samuelson effect in the enlarging Europe." www.iam.fmph.uniba.sk/studium/efm/diplomovky/2008/.../diplomovka.pdf
- Maddala, Gangadharrao and Shaoven Wu.** 1999. "A comparative study of panel data unit root tests and a simplified test." *Oxford Bulletin of Economics and Statistics*. Special Issue, 0305-9049.
- Mihaljek, Dubravko and Marc Klau.** 2004. "The Balassa-Samuelson effect in Central Europe: A disaggregated analysis." *Comparative Economic Studies*, 46: 63-94.
- Mihaljek, Dubravko and Marc Klau.** 2008. "Catching-up and inflation in transition economies: the Balassa-Samuelson effect revisited." BIS Working paper 270.
- Palic, Mirjana.** 2009. "Is the Balassa-Samuelson effect still relevant factor of real appreciation: Lessons for South Eastern European countries?" *ESCE-Les cahiers de recherche*, 11.
- Paun, Cristian.** 2010. "An empirical estimation of Balassa-Samuelson Effect in case of Eastern European Countries." *Oeconomica Journal*, Vol. 1.
- Pedroni, Peter.** 1997. "Fully modified OLS for heterogeneous cointegrated panels and the case of purchasing power parity." <http://web.williams.edu/Economics/wp/pedroniaie.pdf>.
- Pedroni, Peter.** 1999. "Critical Values for Cointegration Tests in Heterogeneous Panels with Multiple Regressors." *Oxford Bulletin of Economics and Statistics*, special issue, 0305-9049.
- Pedroni, Peter.** 2004. "Panel cointegration: asymptotic and finite sample properties of pooled time series tests with an application to the PPP hypothesis." *Econometric Theory*, 20: 597-625.
- Pesaran, Hashem, Yongcheol Shin, and Ronald Smith.** 1998. "Pooled mean group estimation of dynamic heterogeneous panels." ESE Discussion Paper 16.
- Rawdanowicz, Lukasz.** 2004. "Panel estimations of PPP and relative price models for CEECs: Lessons for real exchange rate modeling." Center for Social and Economic Research, Studies and Analyses Working paper 276.

Rother, Philipp. 2000. “The impact of productivity differentials on inflation and the real exchange rate: an estimation of the Balassa-Samuelson effect in Slovenia.” IMF Staff Country Report, 00/56.

Simon, Andras and Mihaly Andras Kovacz. 1998. “Components of the real exchange rate in Hungary.” National Bank of Hungary Working Paper 1998/3.

Sonora, Robert and Josip Tica. 2009. “Harrod, Balassa and Samuelson (Re)Visit Eastern Europe.” <http://web.efzg.hr/repec/pdf/Clanak%2009-07.pdf>.

Wagner, Martin and Jaroslava Hlouskova. 2004. “What’s really the story with this Balassa-Samuelson Effect in the CEEs?” Working Paper 04-16, Department of Economics, University of Bern.