INFLATION IN ROMANIA AND ITS EVOLUTION IN VIEW OF ACCESSION TO THE EUROZONE

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ABSTRACT

In recent decades, the main problem of the world economy was a general rise in prices of goods. The pressure generated by the increase in prices leads to significant distortions in the monetary, economic, political and social areas. Inflation is the main factor of economic crisis by discouraging investment and causing migration of capital. The deteriorated stability created by inflation is strongly affecting private sector decisions to invest or develop, with final effects in reducing production and eventually stagnation. After years of high inflation, Romania has faced in recent years with a significant process of disinflation. This has very strong implications in the development of Romania's economy and foreign trade activity. In econometric models, the main statistical indicator for inflation rate is HIPC. Accession to the EU increases the importance of the HICP. Inflation nominal convergence criteria for joining the euro area is given by the HICP and the ECB defines price stability as an annual increase in the HICP of less than but close to 2%.

KEYWORDS: *inflation, index of consumer prices, Security Market Line, optimal structure, regression model.*
JEL Classification: *C01, C51, C52, E22, F2, P45.*

INTRODUCTION

"*Inflation is always and everywhere a monetary phenomenon*" M.Friedman.

Monetarists claimed that when the money supply is evolving faster than the growth rate of national income, the inflationary phenomenon will occur.

Modern economic thinking is based on the quantity theory of money, which is mentioned by J.Locke. It is based on the fact that the purchasing power of money is determined by the intersection of supply and demand for money. "This theory is essentially an application of the general theory of supply and demand on the special court for money" L.Von Mises.

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The quantity theory of money is expressed as MV = PN, where M is the money supply, V is velocity, P = price index, N = national income. By this equation, the monetarists argue that what produces inflation is unduly increasing the money supply.

V.Slăvescu was characterising inflation as "immeasurable creation of monetary signs" or "an excess of circulation of money." (Slăvescu, 1932)

The market economy exists because of the signal transmitted through prices. When in an economy is a steady state, which has a normal economic growth and reduced unemployment rate to its natural level with a balanced state budget, the inflation rate should be reduced. However inflation is maintained at a similar level year after year. A cause of maintaining inflation could be given by enhancing product quality and their modernization.

P.A.Samuelson, claimed in the second edition of "Economics" that an annual inflation rate of 5% is an acceptable goal. Over four years, in the third edition he said "If price increases could be maintained at an average of 3% per year, such a moderate and steady inflation should not be a reason for concern ". (P.A Samuelson, 1951). At the publication of the fourth edition in 1958, the reference level to fell to 2%, and at the publication of the fifth edition, 1961, under 2%. In the most recent edition, published in 1998 P.A Samuelson does not assess inflation as an "acceptable" one.

In the last thirty years, the school has managed to impose monetarist idea that a lower rate of inflation is desirable despite higher one. This view is based on the fact that, in the long term, economic growth is not influenced by inflation (than, at most, by downsizing it!), so inflation does not bring anything good.

M.Walden answers the question "What is the ideal inflation rate? " This question was circulated by economists for decades, and the conclusion at the moment - if you can say that economists agree on one thing - is that a inflation rate of 1-2% is optimal. "

INFLATION BY DEMAND

Inflation by demand is favourite to occur when aggregate demand in an economy outperforms the aggregate economy. This implies higher inflation while GDP increases and unemployment decreases as the economy moves along the Phillips curve. This is usually described as "too much money for too few goods". Specifically this would have described as "spent too much money for too few goods" because only money spent on goods and services can cause inflation. This would not be expected to persist in time due to supply growth, unless the economy is already at a full employment.

According to Keynesian theory, most companies will hire more people employed and aggregate demand will increase. This increased demand will make firms hire more staff to produce more. Due to capacity constraints, this increased production will become so small that asset price will increase. At first, unemployment will decrease, going from AD1 to AD2, which increases Y (Y2-Y1). This increase in demand means the need for more workers, and AD will translate from the AD3 AD2, but this time there will be much less than in the previous pass, the price level increasing from P2 to P3, an increase much higher than in the previous pass. This increase in price is known as inflation.

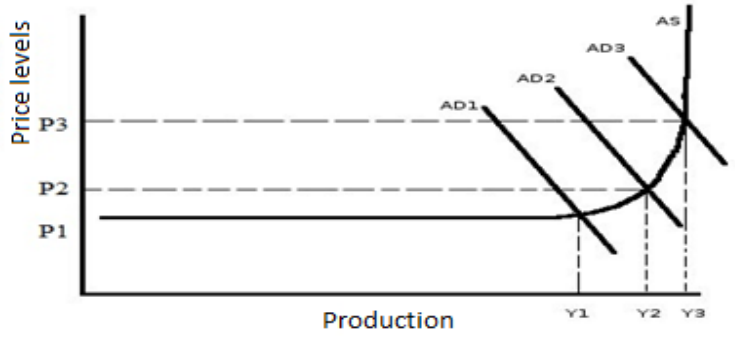


Figure 1. Aggregate demand increasing faster than production

Inflation by demand occurs when aggregate demand grows faster than the supply base. This may be easier to imagine if we look at the offer as capacity level. If the ability to produce is growing at 3% and demand increase at the same pace or slower then we have no problem. We produce everything we need. However, if capacity increases to 3% but demand is growing faster, then we have a problem. In fact, we have "too much money for too few goods" and fail to produce everything we need. Something has to give up, this thing being made by the prices that are forced to grow, this way inflation appears. It can be seen in Figure 1 that when aggregate demand curve moves to the right, the price increases resulting inflation. There are lots of reasons for increased aggregate demand and to realize this we need to look closely at the components of aggregate demand.

$$\mathbf{AC = C + I + G + (X - M)}^{1}$$

Therefore, an increase in aggregate demand might exist because consumers are spending more, maybe because interest rates are down, taxes were reduced or simply because there is a higher level of consumer confidence. It could be because companies are investing more in future growth expectations. It could be that the fact that the government increase spending on defense, education, health, etc. Whatever, it will be inflationary if demand grows faster than supply.

It would be nice to stop at that point and we could say that we understood inflation, but is not so simple. There are differences between economists about the causes of change in demand and also on the effects that these changes have.

The effect of change of aggregate demand depends on ht shape of aggregate supply and here, economists are divided. There are two specific ways: Keynesian way and Classical way. The classical economists have a fundamental belief in free markets called "laissez-faire economy." They think the economy should be left free, that it will find that independent full balance. If the economy is below full employment, the following things will happen: unemployment (surplus labor) → → →lower wages → → → more workers are employed resulting full employment is restored. This process happens automatically through the market mechanism, so there is no need for the government to intervene in the long term. This means that aggregate supply curve on long term (AS) will be vertical.

[1] C=consumer expenditure I=investment G=Government Expenditure X=Exports M=Imports

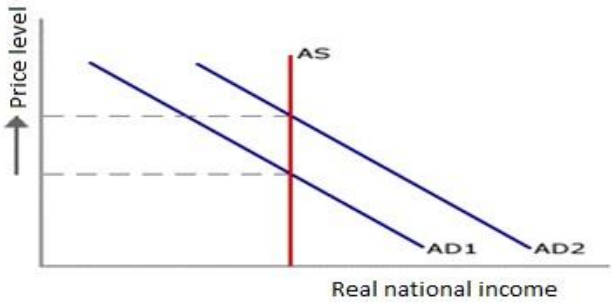


Figure 2. Vertical aggregate supply (AS)

Any attempt to stimulate the aggreagate demand on long term by using reflationist policy, will be simply an inflationary movement because the AD curve will shift upward to the AS curve. In the short term they recognize that the AS curve will be upward sloping due to negative yield, but any reflationist policy will be in a continuous storage of inflation for the future.

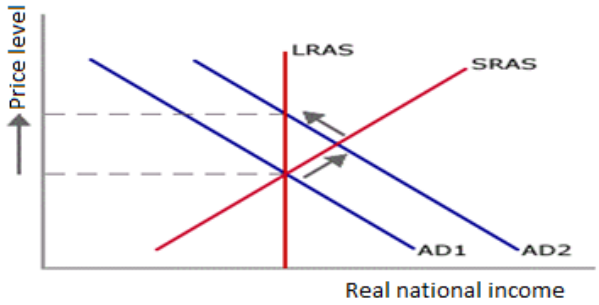


Figure 3. Long-term aggregate supply curve

In this graphic we can see that the reflationist policy has changed demand curve to the right which increased real output in the short term, but long-term increase in prices erased this and there was no overall increase in the real level of production.

Keynesian economists had a different view of work in the labor market and argued that it does not work perfectly. They find that salaries are hardly went down. This means that any increase in unemployment will not necessarily lead to a drop in wages. This means that an employee that has been fired once will not be rehired. Dropping unemployment means a state intervention to stimulate demand enough to be employed as many people again. They argue that on both long-term and short-term, AS curves will be the same and that to reduce unemployment, the government should use reflationist policies to stimulate demand. The classical economists stand up for “laissez-faire” or the state should not interfere in the economy, while Keynesians are for government intervention.

The difference between classical and Keynesian policy can be summed up in their approach. The classical economists argue for "laissez-faire" or that the state should not intervene in the economy, while Keynesians are for government intervention.

COST-PUSH INFLATION

Inflation through costs is defined as a phenomenon in which general price levels increase (inflation) due to increased costs of wages and raw materials. This is determined by supply factors (cost-push inflation is different from the demand that arises undergoing aggregate demand growing faster than aggregate supply).

Inflation through costs can lead to lower economic growth and often causes a decrease in living standards, although often proves to be a temporary thing.

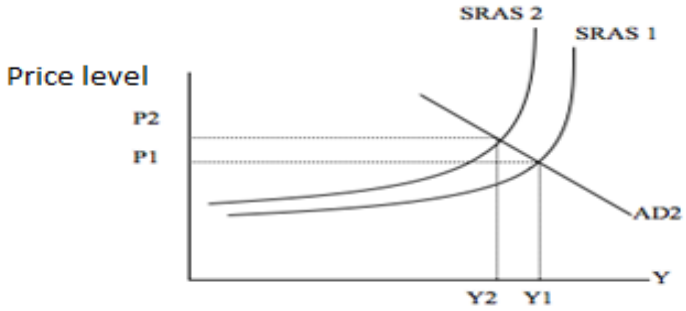


Figure 4. Inflation through costs

THE NOMINAL CONVERGENCE CRITERIA FOR EURO ADOPTION

The Maastricht Treaty provides for achieving a "high degree of sustainable convergence" as a precondition for euro adoption by a member state. Assessing whether this requirement is met it is performed by reference to the following criteria:

- Price stability: inflation should not exceed by more than 1.5 percentage points the average inflation rate of the three EU Member States that had the best results in terms of price stability
- The sustainability of the fiscal position: the budget deficit not exceeding 3% of GDP and public debt at 60% of GDP
- Exchange rate stability: observance of the normal fluctuation margins provided for ERM II for at least two years without devaluing the national currency
- The convergence of long-term interest rates: their average does not exceed by more than 2 percentage points the average rate of the three EU Member States that had the best results in terms of price stability

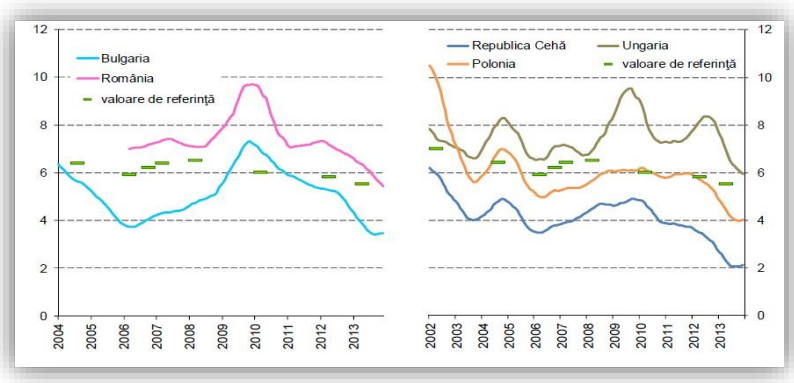


Figure 5. Harmonized Index of Consumer Prices (HICP) annual average (%)

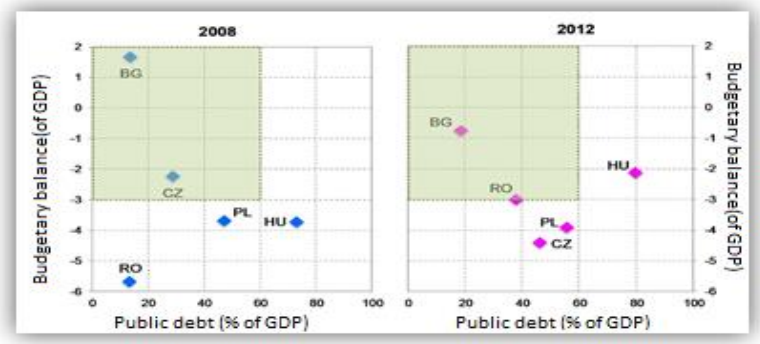


Figure 6. Excessive deficits have been adjusted and will be removed in the near future
Interest rates are below the reference value in most states. 1

MAASTRICHT CRITERIA (NOMINAL CONVERGENCE INDICATORS) [2]

Nominal convergence indicators	Maastricht Criteria	Romania	Difference compared to criterion
The inflation rate (HICP) (percent, annual average)	≤ 1.5 pp above the 0.3% * (average of 3 best performing EU members)	3.2 (december 2013)	+1,4 pp
Long-term interest rate (percent, annual average)	≤2 pp above the 3.4% ** (average of 3 best performing EU members in terms of price stability)	5,4 (december 2013)	
The exchange rate against the Euro * (appreciation (+) / depreciation (-) Percentage)**	±15 percent	+0,8 / -6,6	

[1] Sources: Ameco, Eurostat, BNR
[2] Sources: Eurostat, INSSE, BNR, MFP

The consolidated budget deficit ** (percent of GDP)**	less than 3 percent	3.0	
Public debt ** (percent of GDP)**	less than 60 percent	38,0	

*) reference level December 2013 (Cyprus, Latvia, Bulgaria).
**) reference level December 2013 (Bulgaria, Latvia).
***) Calculated as the maximum deviation of the exchange rate against the euro during February 2012 - January 2014 compared to the average recorded in January 2012, based on daily data.
****) 2012; ESA95 methodology.

CASE STUDY

Romania's EU accession requires an increase in the importance given to the harmonized index of consumer prices (HICP) because the nominal convergence criteria for inflation that needs to be fulfilled for entry into the eurozone is expressed in terms of the HICP and the ECB defines price stability as being given by an annual growth of the HICP below 2%, but close to this level. Thereby a brief analysis of the concept and definition of differences from the national (IPC) is needed.

HICP measures the changes in prices and tariffs for goods and services covered by the retail trade in Romania, the weighting coefficients being derived from the structure of expenditure for this purpose by Romanian and foreign consumers. Therefore, the harmonized index is based on "internal" consumption concept, taking into account consumption of all households on the economic territory of the country. Specifically, the index definition requires not only consideration of residents consumption, but also the costs incurred by foreigners in Romania.

From a conceptual standpoint, this is a major difference from the CPI, which uses the principle of "national" consumption or intended consumption expenditure of residents whether those are performed within or outside the country.

Another difference between the HICP and national definition methodology consists of using the HICP concept of "net expense reimbursements" for medicines (deducted amounts offset) and insurance premiums (deducted compensation).

Between the national CPI and HICP definition there are a number of differences at a conceptual level, but their influence on the final outcome is marginal - less than 0.1% at annual rates in the period 2007-2014 (Table 1). The motivation for this is the insignificant share owned by the expenditure of foreign tourists in Romania and Romanian citizens abroad respectively, an explanatory element is probably insufficient statistical information on the two components.

Table 1

INFLATION RATE[1]	2007	2008	2009	2010	2011	2012	2013	2014
EU	2.3	3.7	1	2.1	3.1	2.6	1.5	0.6
Romania	4.9	7.9	5.6	6.1	5.8	3.4	3.2	1.4
USA	2.6	4.4	-0.8	2.4	3.8	2.1	1.3	1.3

The main aim of the monetary authorities in Romania after EU accession was to keep inflation in the proposed target. In this context it is necessary to develop a model to study the development of inflationary process due to several significant factors of influence. A very important variable factor is the average interest rate on credit institutions with direct implications in domestic demand. Other variables that influence are net income and unemployment rate. All these conditions are taken into account in the development of multiple regression models for Romania in the EU.

In recent decades, the main problem of the world economy was a general rise in prices of goods. The pressure generated by the increase in prices leads to significant distortions in the monetary, economic, political and social environment. Inflation is the main factor of economic crisis by discouraging investment and causing migration of capital. The deteriorated balance created by inflation strongly affects private sector decisions to invest or develop, with final effect in reducing production and eventually stagnation.

After years of high inflation, Romania faced in recent years with a significant process of disinflation. This has very strong implications in the development of Romania's economy and foreign trade activity. In recent years, inflation was close in all periods in the lower half of the target band. Over this period, the main source of disinflation performance was volatile prices, whose annual growth rate has slowed further in recent times.

In the econometric models, the main statistical indicators for inflation is the Consumer Price Index (CPI). Inflation rate models from the paper are based on the evolution of this index. Accession to the EU increases the importance of the harmonized index of consumer prices (HICP). Nominal convergence criteria for inflation joining the euro area is given by the HICP and the ECB defines price stability as an annual increase in the HICP lower but close to 2%.

HICP measures changes in retail prices of goods and services in Romania, weights to calculate the index being extracted from the structure of consumption expenditures of residents and non-residents. In fact, the definition of the index requires consideration not only of consumption by residents, but also the costs incurred by foreign visitors in Romania.

The status of the two indices has not changed after Romania's EU accession, except HICP increased frequency of economic analysis, particularly for comparing the performance of inflation with other Member States. The HICP does not aim to replace national CPI, but to ensure comparability at European level.

To develop a regression model of inflation underlining the importance of the main factors of influence is needed. These factors are very diverse as the action in the national

[1] Source: *Eurostat*

economy and external sources. Of the large number of factors influencing inflation only factors with a significant share in inflation in Romania will be selected.

After a preliminary analysis, it appeared that the main factors influencing the inflation rate in Romania are:

Table 2

The labor market	The labor market is an economic space where they meet face and freely negotiate supply and demand for labor.	J.M.Keynes (1936) M.S.Morgan (1995) D.F.Hendry (1995)
Exchange rate (EUR / RON)	Represents the price of currency units of the currency of a country expressed in monetary units of another country. A more precise definition of the exchange rate takes into account the type of quotation linking the two currencies participating in the exchange rate	C.Şipoş (2006) C.Preda (2006)
Interest rate	The interest rate used as a reference for contracts providing for interest adjustment. This may take the form of an index reference currency (Euribor, Libor, etc.), the interest rate on government securities or an internal rate of interest.	T.C.Mills (1993) R.N. Markellos (1993)
Industrial Production Price Index (IPPI)	IPPI measures changes of prices for goods and / or services manufactured and delivered during the first marketing stage by domestic producers in a certain period (called current period) as against a previous period (called base or reference period).	D.L.Rubinfeld (1998) D.Salvatore (2002) D.Reagle (2002)
Monetary aggregate (M2)	Money supply components as fully existing funds in a country's economy at a time or on average over a certain period, are studied using monetary aggregates. M1 is the mass of narrow money and broad money M2 is intermediate.	M.L.Berenson (2004) D.M.Levine (2004) T.C.Krehbiel (2004)
Non-governmental credit	Non-governmental credit is the credit granted to individuals and companies. Since the peak in 2008, the balance of loans continues to fall and the economy continues to contract. RON loans is in most cases consumer loans to households and loans to finance current capital for companies.	C.T.Mills (1993) W.Wasserman (1996) J.H.Stock & M.W.Watson (2003)

The first important influencing factor for inflation in Romania is the labor market. The most important indicators of the labor market are unemployment rate and the net income of employees. The unemployment rate was significantly lower in recent years in Romania, with direct implications in the process of slowing inflation. In the past three years, net income of employees in Romania's has been steadily increasing, with direct impact on inflation. Unifactorial regression models between CPI and unemployment rate (RS), respectively, between CPI and net income (VN) show strong linear connection during 2007-2014 (Table 3 and 4).

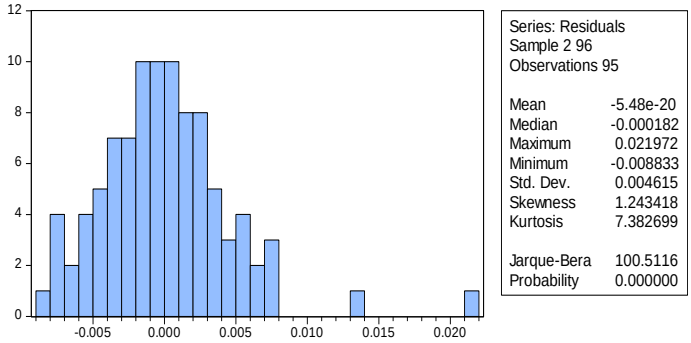
Table 3. Linear regression model between CPI and Unemployment

Dependent Variable: IPC				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.003637	0.000476	7.640436	0.0000
RS	0.008128	0.019098	0.425624	0.6714
R-squared	0.001944	Akaike info criterion		-7.887678
Adjusted R-squared	-0.008788	Schwarz criterion		-7.833912
F-statistic	0.181156	Hannan-Quinn criter.		-7.865952
Prob(F-statistic)	0.671365	Durbin-Watson stat		1.366875

Table 4. Linear regression model between CPI and net income

Dependent Variable: IPC				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.003401	0.000473	7.185926	0.0000
VN	3.46E-05	1.45E-05	2.380679	0.0193
R-squared	0.057442	Akaike info criterion		-7.944889
Adjusted R-squared	0.047307	Schwarz criterion		-7.891124
F-statistic	5.667633	Hannan-Quinn criter.		-7.923164
Prob(F-statistic)	0.019320	Durbin-Watson stat		1.425273

In both tables adjusted R-squared is relatively close to 0, which means that the connections between the evolution of the CPI and unemployment, respectively, net income in the period studied are strong.



For a normal distribution:

- Coefficient of asymmetry (skewness) is 1.24, it means the normal distribution is asymmetrical.

- Kurtotic (kurtosis) 7.382. As this indicator is less than 3, the distribution is called leptokurtotic.

According to this model, media distribution is less than zero, it presents a negative asymmetry and the kurtosis has a value over 3, which means the distribution is leptokurtotic.

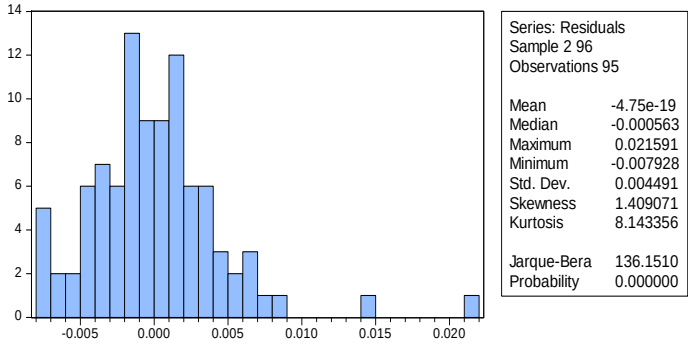
Weibull distribution is a skewed asymmetry distribution coefficient dependent on the value of the parameter shape. The degree of degradation as we move away from the center depends on the value of the parameter shape. For this dataset, the asymmetry coefficient is 1.24 and kurtosis is 7.38, which indicates a moderate asymmetry and kurtosis.

Table 5. Linear regression model between the CPI and the exchange rate

Dependent Variable: IPC				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.003668	0.000482	7.615476	0.0000
RSCH	-0.010007	0.025549	-0.391672	0.6962
R-squared	0.001647	Akaike info criterion		-7.887380
Adjusted R-squared	-0.009088	Schwarz criterion		-7.833614
F-statistic	0.153407	Hannan-Quinn criter.		-7.865655
Prob(F-statistic)	0.696196	Durbin-Watson stat		1.346675

Table 6. Linear regression model between CPI and interest rates

Dependent Variable: IPC				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.004018	0.000491	8.180386	0.0000
RD	0.031046	0.013395	2.317645	0.0227
R-squared	0.054604	Akaike info criterion		-7.941883
Adjusted R-squared	0.044438	Schwarz criterion		-7.888117
F-statistic	5.371480	Hannan-Quinn criter.		-7.920158
Prob(F-statistic)	0.022662	Durbin-Watson stat		1.525292



In Table 5 and 6 R-squared and Adjusted R-squared values are close to 0, which means that the links between the evolution of CPI, exchange rate and interest rate are not very strong. The last set of variables affecting inflation in Romania is given by the producer price index (PPI), money (MM2) and non-government credit (CNV). Unifactorial linear models for these three indicators during 2007-2014 are shown in Table 7, 8 and 9.

Table 7. Linear regression model between CPI and producer price index

Dependent Variable: IPC				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.003547	0.000468	7.575201	0.0000
IPP	-0.008700	0.004255	-2.044504	0.0437
R-squared	0.043013	Akaike info criterion		-7.929697
Adjusted R-squared	0.032723	Schwarz criterion		-7.875931
F-statistic	4.179996	Hannan-Quinn criter.		-7.907972
Prob(F-statistic)	0.043730	Durbin-Watson stat		1.357901

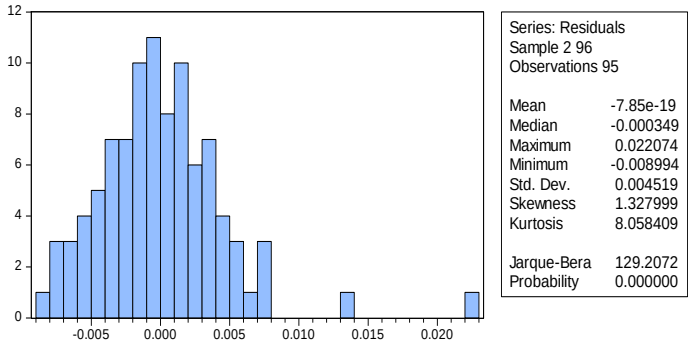
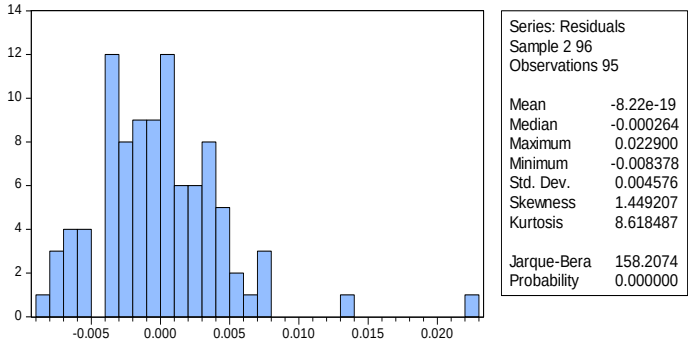


Table 8. Linear regression model between IPC and MM2

Dependent Variable: IPC				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.003543	0.000523	6.774766	0.0000
MM2	0.009583	0.021367	0.448513	0.6548
R-squared	0.002158	Akaike info criterion		-7.887893
Adjusted R-squared	-0.008571	Schwarz criterion		-7.834127
F-statistic	0.201164	Hannan-Quinn criter.		-7.866167
Prob(F-statistic)	0.654826	Durbin-Watson stat		1.402128

Table 9. Linear regression model between IPC and CNV

Dependent Variable: IPC				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.003355	0.000519	6.465414	0.0000
CNV	0.032815	0.024824	1.321933	0.1894
R-squared	0.018444	Akaike info criterion		-7.904348
Adjusted R-squared	0.007889	Schwarz criterion		-7.850582
F-statistic	1.747506	Hannan-Quinn criter.		-7.882622
Prob(F-statistic)	0.189433	Durbin-Watson stat		1.471942



In the case of monetary and non-government credit, the influence has a gap of one month. As with other variables in Tables 7, 8 and 9 R-squared and Adjusted R-squared values are pretty close to 0, which means that the links between the evolution of CPI, PPI, money

supply and governmental credit are strong, it can be seen a negative slope during the crisis on PPI (it halved its value since January 2009).

Durbin Watson statistic (DW) is a statistical test to test serial correlation of errors. If errors are not correlated, then the value of DW will be around 2.

After the main influence factors were found and explain the next step is developing multiple regression model of inflation. It is a classic regression model with standard parameters. The regression coefficients are estimated with the method "Least Squares".

The positive estimated coefficient RS (unemployment rate) and VN (average net income) means that in the studied periods, unemployment rate, average net income (two interrelated factors for the labor market) and of CPI have similar tendencies. It can be observed a negative influence of exchange rate and production price index. Romanian RON depreciation against the euro has accelerated, especially in the last year. The main forces behind the Romanian currency depreciation were lower inputs of capital and unfavorable business conditions in the domestic market. The negative value of the estimated coefficient PPI means that PPI has been growing withing the studied periods while CPI has decreased. Producer prices inflationary pressures for industrial products have remained high. Agricultural prices have increased significantly, both in the vegetable and animal products, this impact being felt strongly at the beginning of the crisis.

Table 10. Linear Regression Model of CPI

Dependent Variable: IPC				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.003330	0.000575	5.794955	0.0000
RS	0.002368	0.020915	0.113217	0.9101
VN	0.032383	0.018425	1.757543	0.0823
RSCH	-0.088414	0.033707	-2.622982	0.0103
RD	0.029135	0.013582	2.145075	0.0347
IPP	-0.009631	0.004973	-1.936491	0.0561
MM2	0.021733	0.024144	0.900118	0.3705
CNV	0.049536	0.029225	1.694991	0.0937
R-squared	0.187047	Akaike info criterion		-7.966497
Adjusted R-squared	0.121636	Schwarz criterion		-7.751434
F-statistic	2.859599	Hannan-Quinn criter.		-7.879596
Prob(F-statistic)	0.009830	Durbin-Watson stat		1.544304

CONCLUSIONS

The market economy exists because of the signal transmitted through prices. Prices are showing the position towards which the demand is going, supply adapting accordingly. So, to take account of this: when the demand for a product increases, there will be an increasing trend on the price of the product. The manufacturer, seeking higher returns, increases production, which leads to restoring the balance between supply and demand. The opposite plan, when the demand drops, the price drops also, directing to another product manufacturer. This proves that price stability does not mean also their fixity: the prices of certain items rise, others fall, depending on the evolution of supply and demand on the market.

Changes of prices occur when production conditions are changed. Once with the development of the technology, gains induced by those will result in the end in lowering of prices. There is also the reverse effect in which difficulties appear in obtaining raw materials and also severe measures imposed by environmental organizations lead to a rise in prices - followed by adaptation to the new conditions of use.

There are, of course, periods where all prices have an upward trend. Inflation has become a lengthy process after they have been scattering paper money after the connection between the precious metal and money has decreased.

When in an economy exists a steady state, which has a normal economic growth and a reduced unemployment rate to its natural level with a balanced state budget, the inflation rate should be reduced by a few percent annually. However inflation is maintained at a similar level year after year. A cause of maintaining inflation could be given to enhancing product quality and their modernization.

Inflation reduces the value of money: initially, it was possible to be able to buy a product at a certain price, a bread for one monetary unit, for example. After the effects of inflation you will have to pay more for the same goods, for example, the same piece of bread will cost 1.5, 2 or even 2.5 monetary units. As a result, the amount of money available reduces and the amount of money that could be saved is now spent to cover additional costs needs.

This reduction directly affects the purchasing power. With the rising prices of basic commodities such as sugar, fuel, vegetables, etc. you will have to spend more money to buy the same quantity of goods.

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