CENTRE FOR EUROPEAN REFORM
policy brief

The euro and prices

By Katinka Barysch

★ One year on, the introduction of euro notes and coins can only be labelled a success. Europeans quickly became used to their new money.

★ The prices of some small-ticket items rose during the changeover. But the effect was so small as to be statistically insignificant.

★ Not all goods will cost the same across the eurozone. But the euro will add to competitive pressures, thus pushing prices down. EU governments should reinforce this effect by speeding up the liberalisation and integration of markets for goods and services.

By most measures, the euro's first year been a success. Doomsayers had predicted that the currency changeover would cause mayhem on European high-streets, long queues in front of cash machines and a wave of crime and forgery. In the event, the participating countries adapted to the new currency quickly and smoothly. There were remarkably few technical glitches and not a single big euro disaster. Travel on the continent, meanwhile, has become a great deal easier, and there is some evidence that the euro is boosting cross-border business.

Facts and fiction

However, despite the fact that the introduction of the common currency was one of the biggest events in the EU's 50-year history, the euro's first birthday celebrations were remarkably subdued. Although around half of all people in the eurozone say they are happy with their new currency, this number has been falling in recent polls. Faced with sluggish economic activity and growing unemployment, many people in Germany and elsewhere did not feel like celebrating. Some claimed that the euro itself should be held responsible for Europe's economic woes. "The euro isn't working", concluded the 'no' campaign which opposes British entry, in a note on the currency's birthday. Critics of the new currency say that it has pushed up prices and eaten into the budgets of European households. They also claim that the euro has stifled economic growth and contributed to high unemployment. Some fear that the euro could push Germany, the eurozone's biggest economy, into Japan-style deflation.

European citizens, inside and outside the eurozone, are understandably confused. How can the euro push up prices and lead to deflation at the same time? How can it simultaneously stimulate business activity and strangle the eurozone economy?

To separate facts from fiction, it is important to distinguish between two crucial steps on the way to economic and monetary union (EMU). At the start of 1999, the 12 participating countries locked their exchange rates and transferred monetary policy to the European Central Bank (ECB). They also agreed to a set of fiscal rules (the stability and growth pact) to underpin the new currency. There is now a lively debate about whether ECB policy is right and whether the stability pact allows member-states enough room for fiscal manœuvre (see for example: Jean-Paul Fitoussi and Jérôme Creel: *How to reform the ECB*, CER 2002). But this debate is separate from the much more straightforward question of whether the introduction of euro notes and coins at the start of 2002 has brought benefits to European businesses and consumers.

Travel across the continent has undoubtedly become easier. Europeans no longer have to queue in front of foreign exchange booths, pay exorbitant commissions to banks and money changers in holiday resorts or make complex calculations to figure out the price of a pizza or train ticket abroad. But the euro was supposed to bring benefits not only for travellers, but also for those staying at home. By making prices easily comparable across countries, the common currency should increase competition and push down the prices of goods and services. However, the vast majority of Europeans – 85 per cent, according to a euro survey carried out in November 2002 – are convinced that the euro had exactly the opposite effect. Most think that shops rounded prices up by a cent or two when the new currency was introduced. Worse, many suspect that shopkeepers, hairdressers and kiosks exploited the confusion of the currency changeover to hike their prices by much more than could have been justified by rounding. Although most eurozone governments reached 'price stability agreements' with business representatives, these were not effective in all cases. Governments and consumer associations managed to monitor prices in large supermarkets and fast-food chains, but not in corner shops or cafés or at taxi ranks.

The 'teuro' debate

In Germany, for example, where the conversion rate was close to a straightforward DM2 to €1, there have been examples of shopkeepers simply replacing the deutschmark sign with a euro one, raising prices by 100 per cent in the process. Some vending machines were converted straight from DM1 to €1. The price of kebabs often went from DM3 to €3, or something similar. In France, which swapped the franc at Fr6.6 to €1, such cases were rarer since the complicated exchange rate led to a more widespread use of dual price tags. Also, since most French people shop in large supermarkets, monitoring price developments was easier than in, say, Greece, where markets and corner shops play a larger role.

The euro has turned into a 'teuro' (*teuer* meaning expensive), lamented German consumers. The German government hastily summoned retailers for a series of 'teuro' meetings. Consumer associations across the eurozone stepped up their monitoring activities, while newspapers and TV stations named and shamed shops suspected of 'unfair' price increases. In Greece, consumers staged a four-day boycott of shops and services to protest against price rises.

The European Commission and the ECB appeared largely to ignore the uproar. They pointed to inflation statistics that showed little or no impact of the currency changeover. True, in January 2002, when the euro first hit the highstreets of Europe, consumer price inflation jumped to 2.7 per cent year on year, compared with 2 per cent in December 2001. But inflation came down quickly afterwards, and for 2002 as a whole it was actually lower than the year before (2.2 per cent, compared with 2.5 per cent). Eurostat, the EU's statistical agency, explained that the price rises in early 2002 had more to do with bad weather, which pushed up food prices, than with the euro. The euro may have led to some prices rises, Eurostat belatedly conceded, but it should have contributed no more than 0.2 percentage points to first-half inflation in 2002.

Eurozone inflation in the six months to June

All items	1.4
of which:	
Food	2.2
Alcohol & tobacco	2.8
Clothing	0.9
Housing	0.4
Transport	1.3
Hotels, restaurants & cafés	2.5
Communications	-0.6
Energy	-0.2

2002, in per cent

Source: European Commission

Europeans refused to believe that they were simply imagining the price rises. The result was an unprecedented gap between actual inflation (as measured by statistical agencies) and perceived inflation (as measured by surveys of European consumers). Even by the end of 2002, Europeans thought that year-on-year inflation was running at more than twice the officially recorded rate. This matters because high inflation prompts workers to ask for bigger wage packages to safeguard their purchasing power. Higher wages, in turn, boost demand, which may push up prices. The perception of high inflation may turn into a self-fulfilling prophecy.

A beer and a washing machine

The discrepancy between statistics and public opinion is easy to explain. Many items did indeed become more expensive, and not only with the birth of the euro. Department stores and supermarkets across Europe started quoting dual prices in mid-2001 to give their customers more time to get used to the conversion rates. It was then that most retailers rounded prices up to arrive at a neater euro rate. A survey by the German consumer association (VZBV) found that most euro-related price rises in German shops and department stores took place before the introduction of notes and coins. After January 2002, price changes continued at a slower pace, and for each good that became more expensive there was another one that became cheaper. Small businesses – such as cafés, kiosks and dry cleaners – often waited until the last minute to quote new prices. This is why price rises in those areas were particularly pronounced in early 2002. Statistics show that restaurants and cafés hiked prices more than other sectors. In Spain, for example, such prices rose by 8 per cent in the course of 2002. But not all restaurant owners could be accused of profiteering. Since printing a new menu or price list costs money, many small businesses waited for the arrival of the euro to implement price changes that they had planned anyway.

Shoppers take note mainly of the prices of frequently bought goods: a train ticket, a newspaper, a haircut. While these items are important for everyday life, they account for only a small portion of total household expenditure. And since consumer price indices are construed to reflect average household expenditure, these everyday items also have little impact on overall inflation figures. Europeans cried foul because it was exactly those small-ticket items that became more expensive after the euro introduction. This effect was reinforced because the currency changeover made people unusually vigilant about price developments. Meanwhile, the prices of other, much larger items – cars, computers, washing machines – changed little or even fell. But since few people buy washing machines very often, they have only a vague notion of what they should cost.

If the story is so simple, why did the European authorities, until very recently, insist that the euro had had no impact on prices? It was only in December 2002 that Commission President Romano Prodi referred to certain "unjustifiable" price rises. Otmar Issing from the ECB Executive Council admitted that the Bank had "massively underestimated the impact of marked increases in certain prices… on the perception of the people". And Wim Duisenberg, the ECB President, conceded that "we simply should have been more honest about it". A clear and open communication strategy about the euro's impact on prices would have done much to mitigate confusion.

Since the 'teuro' debate has left many Europeans less than enthusiastic about their new currency, the Commission now wants to take steps to bring the euro closer to the hearts of European citizens – or, as the Commission puts it, facilitate the "psychological changeover". In particular, the Commission has suggested that retailers replace all dual price tags with €-only ones by mid-2003. The Commission then reckons that shoppers would stop calculating in their 'old' national currencies and fully adapt to the new system.

This proposal is misconceived. Just as people living abroad continue to calculate in their home currency for years, Europeans will still use their national currencies as reference values, dual pricing or not. Already, 65 per cent of all eurozone shoppers calculate in euros at least half of the time, but this figure drops drastically when it comes to large purchases, such as cars or houses. The figures also vary widely from country to country. For example, more than two-thirds of French consumers want dual pricing to continue, but only one-quarter of Dutch ones care about this. The decision on how to design price tags should be left to retailers; they know best what their customers want.

The 'teuro' debate is, in any case, a thing of the past. The adjustments that came with the euro changeover were a one-off event. And what little impact they may have had on European price statistics is already fading. Most forecasters expect eurozone inflation to come down further in 2003 and 2004. The euro itself may partly be responsible for this, as the competition effect – which should push prices down – will become stronger over time.

Lower prices everywhere?

So far, there is little clear evidence that the euro has led to an equalisation of prices across countries. In July 2002, seven months after the introduction of euro notes and almost one year after the start of dual pricing, researchers found that the same pair of Levis jeans sold for €55 in the Netherlands but for €75 in neighbouring Belgium. A similar survey in May 2002 found that Germans pay €160 for an Ikea bedframe while the French have to shell out €245. The same month, a BMW 318i cost around €26,000 in Spain and Italy, but €37,000 in Finland (and as much as €52,000 in Denmark, which has stayed outside the euro).

There are several reasons why price differentials may persist despite the introduction of the euro. A sizeable number of Europeans (13 per cent of the population) bought goods in another EU country last year, be it on holidays, through the internet or on a 'booze cruise', and this number is likely to continue growing. But while people may be willing to travel across borders to save money on large purchases, they are unlikely to do so for smaller items. And some, such as hair cuts and other services, do not sell across borders at all. The price of these items will continue to depend on purely local conditions, such as tastes and, most importantly, household income. In fact, in countries such as Portugal or Greece, these 'non-tradeable' goods will become more expensive as income levels catch up with the richer EU members.

Another reason why price gaps persist within the eurozone is different tax rates. Value-added tax ranges from 15 per cent in Luxembourg to 22 per cent in Finland. An Irish smoker pays three times as much excise duty on a packet of cigarettes as a Spanish one. Taxation also accounts for much of the variation in car prices in Europe. The EU has no plans to harmonise tax rates. But retailers could help their customers to compare prices if they quoted them net of tax, at least for larger items.

Cross-border shopping trips pale into insignificance compared with the price pressures exerted by international trade. The establishment of the single European market led to massive price adjustments long before the euro was born. The European Commission found that prices in the EU converged significantly between 1992, when the single market programme was launched, and 1999, the first year of EMU. Since then, however, price convergence has slowed drastically. The Commission puts the blame on sluggish progress with market liberalisation and integration. Prices will only tumble further if the introduction of the euro is matched by a big push to complete the internal market.

One year after the introduction of notes and coins, it is too early to detect retail price reductions brought about by the euro. Even over the medium term, the effect may be difficult to discern. Other factors – oil prices, euro movements against the dollar, consumer demand growth or tax changes – will dominate shifts in inflation. The continued liberalisation and integration of markets for goods and services will determine how fast Europe reaps the economic gains from its new currency. But although the euro will not be the only or even the most important factor influencing prices, it will certainly help to reinforce competition and thus benefit European consumers.

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What Europeans think about the euro

★ 51.5 per cent of people in the eurozone have no difficulties at all with the new money; 93 per cent find it easy to handle the new banknotes and 69 per cent have no problems with the new coins; most think that there are exactly the right denominations; only 20 per cent would like a €1 note (although 40 per cent would not mind a €5 coin).

★ 49.7 per cent are very happy or quite happy with their new currency, but this share varies widely across eurozone countries: in Belgium, almost 80 per cent are happy with the new currency, in Germany only 28 per cent are.

★ two-thirds of those polled agree that the arrival of the euro has been a major event in European history; but 80 per cent say it has made them feel neither more nor less European.

★ almost 85 per cent think that the introduction of notes and coins has led to price shifts that harm consumers; yet only 45 per cent think that it has been harmful to price stability; half of those polled do not think that the euro has reduced price differentials across countries.

★ 29 per cent say they might be spending more than before because they do not fully realise the value of the new money; this is matched by 34 who have become more cautious for fear of overspending.

Source: Gallup Europe, 'Attitudes sur l'euro', November 2002

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