

2007-09-13

PRESS RELEASE

The euro, 5 years later: what has happened to prices?

(Article published in the Economic Review, September 2007)

Now that the euro notes and coins have been in circulation for over five years, it seems a good time to look back at any effect which the euro has had on prices. Even today, the introduction of the euro is often linked to price rises, whereas in reality inflation measured by the harmonised index of consumer prices (HICP) has remained moderate since the changeover, especially in view of the fact that crude oil prices have risen very steeply in the past few years, something which has nothing to do with the euro. Surveys have shown that the fear of price rises was already present even before the introduction of the euro. After the changeover, that feeling became even more acute. Even today, more than five years after the introduction of the euro, the great majority of the population are still convinced that the euro had undeniably driven up prices. This subject recently became highly topical once again, particularly when Slovenia joined the euro area on 1 January 2007.

Specific estimates, produced by institutions such as Eurostat or various national central banks of the Eurosystem, including the National Bank of Belgium, show that the introduction of the euro had only a limited impact on inflation in 2002. For Belgium, that impact was estimated at 0.2 percentage point. However, the effect was concentrated in less competitive sectors, so that it was fairly visible. Since then, inflation has remained low, but there has been greater dispersion in the movement in relative prices. At microeconomic level, the process of price adjustment, which was relatively slow, gave rise to a new attractive price structure and an increase in the number of prices used in the economy. The problems experienced by consumers in getting used to the euro are probably linked to such structural changes. However, these findings suggest that the process of adjusting prices to the euro is correctly reflected in the data used to measure inflation, and that the HICP is an accurate measure of inflation even if consumers may see things differently.

Before the euro was introduced, inflation and inflation perceptions were closely linked, but from the beginning of 2002 a persistent divergence was apparent between the two. The role of the changeover in the emergence of the persistent perception gap is undeniable. That is evident from a chart analysis and is clearly confirmed by a more formal econometric study. However, when it comes to finding more specific explanatory factors, it is difficult to identify their exact contributions. The statement that consumers tend to form their perceptions on the basis of the movement in prices of frequently purchased items is not sufficient to explain a persistent perception gap. The socioeconomic characteristics of the consumers did not play a dominant role either, while the influence of more psychological factors, such as the problems which consumers experience in incorporating the euro in their reference framework, is very difficult to assess.

The specific character of the HICP inflation measure does not appear to have played a significant role in the emergence of the perception gap in the euro area. A similar gap arises if the national CPIs are used as the benchmark instead of the HICP; the non-inclusion in the HICP of the costs of owner occupied housing was not a key factor either. The fact that the accuracy and credibility of the HICP *per se* are not in doubt is reassuring from the point of view of monetary policy.

Despite its size and persistence, the perception gap seems to have had few if any macroeconomic consequences, in terms of either wage costs or consumption. One effect of the common monetary policy has been to ensure that inflation expectations are firmly anchored at a level compatible with price stability. The perception gap is therefore essentially a challenge for communication aimed at the general public. Finally, it should be pointed out that the experience concerning the introduction of the euro is not fundamentally different from what happened in the United Kingdom following the decimalisation of the pound sterling in 1971. There are indications that on that occasion, too, prices were perceived to have risen considerably, whereas the effect on actual inflation was minimal.