

Prices and EMU

EMU study



HM TREASURY

EXECUTIVE SUMMARY

Background **1** The creation of a single currency eliminates exchange rate risk and related transaction costs from purchases across the currency area. It also removes the need for exchange rate conversion when comparing prices across countries. These factors mean that businesses and consumers may be better able to compare prices and purchase the most competitively priced goods from across the single currency area. This could potentially lead to enhanced market efficiency and competition. Consumers would benefit from lower prices, increased quality and/or greater choice. There could also be a dynamic gain, with a shift of resources away from inefficient producers to the most efficient firms within the single currency area.

2 The creation of the Single Market for goods and services in the European Union (EU), along with domestic economic reform, has done much to enhance competition in the EU. The UK Government's White Paper *Realising Europe's Potential: Economic Reform in Europe* (HM Treasury, 2002) contains a detailed discussion of the impact of the Single Market programme on competition, including an analysis of consumer prices in the EU. And the UK Government's latest report reviews progress in this key area.¹ Existing academic work has also been drawn on wherever possible.

Prices and EMU **3** This study extends that work by incorporating recent inflation data to assess the latest trends in prices and also, importantly, to consider the likely impact on UK price trends if the UK were to join EMU (Economic and Monetary Union). It examines what explains relative price level movements between European economies during the 1990s and what has happened to euro area prices since the introduction of the euro – whether they have converged and how euro area price dispersion compares with dispersion in other monetary unions such as the United States.

4 Analysis of this issue is particularly relevant to the growth, stability and jobs test – the fifth of the Government's five economic tests for EMU entry – which includes consideration of the potential microeconomic gains from EMU; and to the second test on flexibility, which considers the role of prices as one of the various adjustment mechanisms available in EMU.

Analytical issues **5** The impact of joining a single currency on prices could have a number of dimensions. Joining EMU could be expected to have some immediate effect on prices because of changeover costs. However, these effects are by their very nature transitional, and less significant than the longer-term effects which could occur as EMU strengthens the Single Market.

6 The theory of arbitrage – and in particular the 'law of one price' – suggests that when there are no underlying barriers to trade, prices should converge to be identical across regions, once adjusted for the costs of trading between regions. Membership of EMU, by reducing currency costs and exchange risks, should – in theory – boost trade activity and competition, putting additional pressure on prices to converge across the euro area.

7 However, other costs of trading (such as transport) would remain. EMU does not, in itself, remove other barriers which place limits on price convergence. So significant variations in prices could be expected to remain within the euro area, particularly in sectors which are less exposed to trade.

¹ *Meeting the Challenge: Economic Reform in Europe* (HM Treasury, 2003b).

8 There is also evidence that prices are ‘sticky’ in response to changes in the nominal exchange rate. When nominal exchange rates change, firms do not always pass on the impact on prices – instead they often choose to insulate consumers from currency volatility. This means that, at any point in time, underlying relative prices can be significantly affected by recent changes in the nominal exchange rate. This makes it difficult to make relative price comparisons across countries.

9 This study includes, at Annex D, a new paper by Professor Holger Wolf of Georgetown University. Professor Wolf is a leading authority on the analysis of price levels and price differentials and his paper sets out the underlying theoretical framework which provides the analytical foundation for this study.

Aggregate analysis of relative prices

10 The relative price level is the ratio of domestic to foreign prices adjusted for the exchange rate between domestic and foreign currency. Having risen since the mid 1990s, the UK’s relative price level peaked at around 19 per cent above the EU average in 2000. It fell back to around 13 per cent above the EU average in 2002 as a whole, continuing to fall through the year and into 2003 reflecting a decline in relative prices driven by sterling’s depreciation against the euro. In January 2003, the UK’s relative price level is estimated to have been around 8 per cent above the EU average. Over the same period, Germany and France have become less expensive relative to the EU average – and Italy has become cheaper.

11 There is some evidence that, at the aggregate level, relative prices are correlated with relative labour costs and overall tax levels, although there is not a strong link with taxes on consumption. These factors would not be directly affected by EMU membership and, therefore, to the extent that they affect UK relative prices, they would remain a source of price dispersion if the UK were to join EMU.

12 Much of the rise in UK relative prices since the mid 1990s is explained by the appreciation of sterling over this period. Movements in the relative price levels of other major European economies were also affected by nominal exchange rate changes. So while there is limited evidence that prices in euro area countries have converged on the EU average since the mid 1990s, this is partly the result of exchange rate movements.

13 Nevertheless, the coefficient of variation for prices in the EU15² – which gets smaller as prices converge – showed signs of declining during the 1990s. There is more evidence of convergence in some sectors than others. Indeed some sectors have shown signs of price divergence. Price convergence appears to be greater in the geographical core of the euro area (France, Germany, Belgium, the Netherlands and Luxembourg) than in the ‘periphery’. It is possible that this is due to an EMU effect – particularly bearing in mind that there were strong market expectations of EMU going ahead before currencies were actually locked in 1999.

Detailed sectoral analysis of prices

14 Detailed sectoral analysis shows that prices for similar goods vary widely between countries in the EU – to the extent that some supermarket goods can be found at half their maximum EU retail price in other Member States. However, there is no European country which is found to have uniformly high or low prices, although UK prices tend to be at the high end for a number of products. This suggests that sectoral factors, such as the degree of competition in different industries and variations in transport costs for different types of goods, are important in explaining existing price differentials. These would not be directly affected by EMU membership.

² This is one of a broad range of indicators for assessing Europe’s performance in economic reform. See *Structural Indicators of European Reform: Measuring Europe’s Progress* (HM Treasury, 2003a).

15 It is difficult to say which UK sectors might experience the greatest degree of price convergence as a result of a decision to join EMU. Price convergence seems to be higher in industries where there are more large firms and more cross-border trade. However, the main impact of EMU membership on price convergence would be likely to come through reduced exchange rate costs. Such costs may be a larger barrier to trade for small firms and consumers than for large firms.

16 Price dispersion is lower in the US than in the EU, suggesting that there is significant scope for further price convergence within the EU. However, it is difficult to know to what extent the lower degree of price dispersion in the US reflects its longstanding and mature currency union, and to what extent it reflects the lack of internal political boundaries and a more competitive general trading environment. What evidence there is suggests that price convergence takes many years to achieve.

The study in the context of the set of EMU studies

17 The focus of this study is on the demand side of the potential microeconomic gains from EMU. Consumers would benefit from lower prices, greater quality and/or increased choice if EMU were to promote increased competition through the removal of exchange rate costs and increased price transparency. However, there would also potentially be dynamic gains on the supply side. Increased competition might promote cross-border trade and investment, and could lead to changes in the industrial environment as firms restructure in reaction to new markets. These issues are considered in other EMU studies.

Conclusions: prices and EMU

18 The evidence surveyed in the study suggests that there is scope for further price convergence in the EU, and between the UK and other European economies. The effect of EMU on price convergence is likely to be greatest where transaction costs and exchange rate risk form a significant proportion of trading costs.

19 However, while EMU should reduce the extent of price divergence, it will not eliminate it – costs such as those of transport and information and local differences in taxes and wages will not necessarily be affected by EMU. Moreover, remaining price differentials are likely to vary across sectors. Overall, the process of price convergence is likely to take a considerable amount of time.

20 These conclusions, in turn, suggest some implications for the relationship between EMU and competition. A single currency has the potential to intensify competition, particularly by increasing the likelihood of cross-border entry into markets. It would only be possible to gain these benefits in full, however, by working in parallel to tackle other barriers to competition in Europe – addressing other impediments to effective competition and well-functioning markets.

21 The Government has pursued reforms to improve competition both in the UK and in the EU. The Enterprise Act has given the UK competition authorities full independence and more effective powers with which to work proactively to promote competition. In Europe, the Government has strongly supported economic reform and has pressed for structural improvements to product, capital and labour markets to make them work better. Earlier this year, the Government reported on progress in *Meeting the Challenge: Economic Reform in Europe* (HM Treasury, 2003b).

22 This study is an input into the assessment of the flexibility test – the second of the Government's five economic tests for EMU entry – and the growth, stability and jobs test – the fifth of the five tests.