

THE INTRODUCTION OF EURO NOTES AND COINS

As of 1 January 2002, an unprecedented currency conversion will add a physical dimension to the twelve euro countries' single currency. Their national notes and coins will be replaced as legal means of payment by 15 billion euro notes and 50 billion euro coins.

The imminent changeover to the euro as a physical currency has raised questions about its conceivable effects, above all on inflation in the euro area. It is primarily the issue of whether and, if so, how inflation will be affected by the introduction of new notes and coins in the euro area that is discussed here. This is relevant for Sweden in that almost 50 per cent of our total imports come from euro countries and 40 per cent of exports go there.

First, however, it should be noted that any one-off shift in the price level that results from the changeover would act as an inflationary impulse over just a limited period. Provided the changeover does not alter inflation expectations, any effects would therefore be less important for monetary policy.

SHORT-RUN EFFECTS ON THE PRICE LEVEL

One hypothesis that has been put forward is that the conversion to euro notes and coins will increase the risk of inflation because price-setters use the opportunity of rounding the "new" euro prices upwards.

There are factors that speak for some upward price pressure in connection with the introduction of euro notes and coins. In that *menu costs* (outlays for preparing and implementing price adjustments) are substantial, prices are adjusted infrequently.⁹ Among Dutch retailers, for instance, about 40 per cent alter prices only once a year (the proportion of Swedish retailers is the same) and 10 per cent do so even less frequently. High menu costs could induce firms to use the conversion as an opportunity for price adjustments because it will entail costs in any event.

Another factor is the common practice of pricing goods at *psychological numbers*, for example 3.99 rather than 4.00 kronor. Studies show that a price reduction from, say, 4.00 to 3.99 kronor would stimulate demand appreciably more than a cut from 3.99 to 3.98 kronor.

9 This refers to the Netherlands, see *Risk of substantial price increases due to euro conversion seems limited*, De Nederlandsche Bank, June 2001. For a Swedish example, see the box on pp. 17–21 in *Inflation Report 2001:3*, Sveriges Riksbank.

The changeover to the euro as the physical means of payment entails an adjustment of prices to new psychological numbers, either upwards or downwards. In view of menu costs and depending on the competitive situation in a particular market, there is a risk that in setting new psychological numbers, firms use the opportunity to raise prices. In a study in the Netherlands, 30 per cent of retailers reported an intention of combining the euro conversion with an adjustment to attractive psychological numbers, while 43 per cent considered they would stick to the existing price level and adjust to more attractive numbers later on.

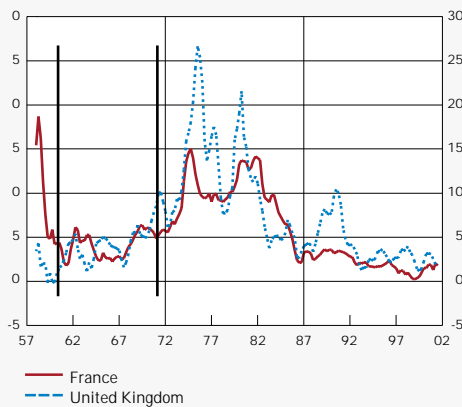
All in all, those who take the opportunity of raising prices and thereby avoiding additional menu costs could contribute to some impact on recorded inflation. But as this would no doubt replace price increases on another occasion, in the somewhat longer run average inflation would probably not be affected substantially. It is also reasonable to assume that some price adjustments to the nearest psychological number would be downwards, though this would mean that the firm has to lower profit margins and/or cut costs.

Consumers are usually aware of what purchases ought to cost and base their decisions on how the asked price relates to this *reference price*. It has been argued that euro prices will complicate such comparisons, at least initially. Meanwhile, an inflationary impulse might be generated in that consumers' faulty assessments lead to euro prices being seen as more attractive. Against this it can be said that information has been widely available and that dual pricing has been commonplace for some time.

EMPIRICAL EVIDENCE

Studies in Finland, France, Germany and the Netherlands have revealed price increases in connection with the euro's introduction as a legal means of payment. One of the cited reasons is upward rounding to the nearest psychological figure. However, historical examples do not provide evidence of increased inflation (Fig. B7). Although there was a transitory increase in inflation in the United Kingdom when a new decimal system was introduced in 1971, there is no empirical evidence that it was just the conversion which pushed prices up. Neither did the conversion to the "new franc" in 1959 lead to higher inflation in France; however, this was one of a number of measures for lowering inflation and restoring confidence in the Fifth Republic.

Figure B7. CPI for France and the United Kingdom.
Percentage 12-month change



Source: IMF.

LONG-TERM EFFECTS OF A MONETARY UNION

The introduction of the euro as a means of payment in the euro area will simplify inter-country price comparisons. Price differences between countries in the monetary union currently average about 16 per cent, which partly has to do with the psychological barrier to calculating in different currencies. Better possibilities of comparing prices will stimulate import demand for goods from the country where the price is lowest. This will result in increased competition and smaller price differences, which should tend to subdue prices. In time, moreover, the single currency should lower business costs — and thereby cut consumer prices — by, for instance, reducing transaction costs, simplifying accounting and financial systems and improving financing opportunities. Other benefits from a single currency could be increased trade and greater integration. All in all, the conversion to physical euro is of minor importance for inflation in the euro area in the short run, while its economic significance in the longer run may be greater.