

A price rise, usually measured by consumer price index and referred to by a central bank, is often slightly different from a price rise that the man in the street perceives. The gap in an actual and perceived price advance is especially wide when the economic environment undergoes changes. Further we shall briefly observe factors which affect distortions of price perception, and how the European Union has attempted to fight the groundless fears concerning the price rise within the present euro area. Perceiving the pace of price increase differently from the reality is an issue in Estonia as well as in many other countries.

PRICE RISE, PERCEPTION OF A PRICE RISE AND RESPECTIVE FEARS

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■ Real and Imaginary Price Rise ■

From 1 May 2004 when Estonia joined the European Union to 1 February 2005 **consumer prices in Estonia grew by 3%**. Most Estonian residents did not perceive the price increase to be that low. The Saar Poll research company's survey¹ in January shows the following:

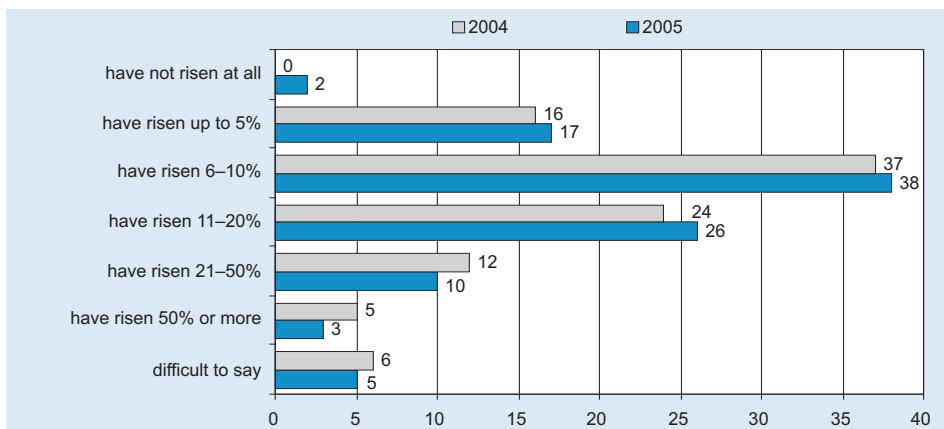


Figure 1. Whether and how much do you think prices of goods and services have recently risen in Estonia since Estonia joined the European Union? (%)

¹ From 20 January to 2 February 2005 the social and market research company Saar Poll conducted a public opinion survey. Oral interviews involved 1,150 persons aged 15–74. The results were compared to the survey results of September 2004.

Compared to September 2004 the Estonian residents' fears of a price rise had slightly decreased by January. Perception of the price rise had become slightly more realistic; however, it was still far from the reality. Expectations of a price rise in the forthcoming years are not as high any more as in September 2004 either.

While in September 2004 the most sensitive area concerning the price rise was **food**, it is housing expenses today. The decreasing share of food on the list may evidently be explained by the fact that the actual price rise of food was actually not as high as feared. An expected rise in housing costs is obviously explained by fears of a surge in the electricity price. The sphere of health care has become an even more sensitive issue for the population compared to the previous survey period.

■ Different People Perceive Price Rise Differently ■

According to the Saar Poll survey non-Estonians, the elderly, the less-educated, those with lower income and those opposing the transition to the euro perceive the price rise to be higher. The residents of Tallinn take the rise to be lower, whereas residents of other towns and rural areas consider it to be slightly higher.

According to a similar survey by Faktum² conducted at the same time, on the one hand, a price rise is perceived to be smaller by business people, managers and top specialists, and on the other hand, by students (young and having no close encounters with daily coping issues?). Out of these groups about 40% estimate the price rise to be up to 5% which may be considered "correct".

People with the lowest income (less than 1,000 kroons a month per family member) often think the post-accession price rise was much higher than it actually was – 45% of the respondents hold the prices increased by 11–20%. We cannot claim, however, that the higher the income, the lower is an elevated perception of the price rise. According to Faktum data the price rise perception largely depends on not only current income levels but also how optimistic or pessimistic future expectations are; the lowest price rise perception is characteristic of a coping type³ who copes well at the moment and has hopes for a **continued prosperity in the future** (41% hold the price rise level is up to 5%, which may be considered "correct"). Classification of responses on the basis of income only shows that persons with higher income levels tend to indicate not the "correct" but a considerably higher price rise range, i.e. 6–10%.

² The research centre Faktum carried out a survey in the form of an oral interview, commissioned by Eesti Pank, during 19–31 January 2005 among Estonian residents aged 15–74. The aim was to find out: 1) expectations of the entire population, their attitudes towards the introduction of the euro and opinions regarding likely changes caused by the introduction of the euro; 2) expectations and attitudes in different media (consumption) and coping types.

³ The Faktum research centre's analyses divide respondents into five coping categories based on the respondents' assessment of their coping in society and on how they forecast changes in coping of their family in the forthcoming years. The more detailed division is: 1) current coping average, the situation is maintained in the near future; 2) current coping average and will worsen in the near future; 3) current coping good, will improve in the near future; 4) current coping bad, in the coming years may improve or worsen or the situation persists; 5) current coping average, changes for the better.

Accordingly, **perception of the price rise depends on a number of other factors in addition to income:**

- whether people monitor prices, whether the respondent is the primary shopper in the family and payer for services;
- person's age and life experience;
- person's education.

Price rise sensitivity is largely influenced by the type of information sources used, interpretation of the received information (emotions and values), consumption habits and desires to consume, desired position in society, content or discontent with the current situation, and so on.

■ Why Perceived Pace of Price Increase Differs from ■ the Official Inflation Indicator

Economic and psychological researches have established that a price rise is always perceived more acutely than a price drop, annoyance caused by a price rise always exceeds pleasure arising from a price drop, and prices are not perceived in an integral framework – a rise in the price of a product is not viewed in relation to a fall in the price of another product. The psychological impact of the price rise is the larger, the more frequently a specific product or service is bought, and the price rise is perceived more acutely in the case of goods purchased for cash.⁴

In order to understand the reasons why the pace of a price increase perceived by Estonians differs from the actual price rise we should **observe what happened to the prices after Estonia became a member of the European Union**⁵. To start, we should stress that in early 2004 the inflation rate in Estonia was exceptionally low (in the first quarter consumer prices grew by a mere 0.4%). This gave a background for an assessment of further price developments. Estonia joined the European Union on 1 May 2004 which was the moment when Estonia's extremely liberal trade policy was timed to be harmonised with that of the EU. An increase in the fuel excise duty close to a minimum level required in the European Union was also set to that moment. In May 2004 the inflation rate increased abruptly in Estonia and prices rose by 2.1%, month-on-month.

The regulation, which favours local agricultural production, applied in the EU and which is now applicable in Estonia, brought about a price increase of the agricultural products imported from non-EU countries by a customs tax (e.g. 64% for bananas). Various export subsidies for agricultural products imported from the EU were abolished and prices surged

⁴ Such issues have been treated by D. Kahnemann, awarded a Nobel Prize in Economic Sciences in 2002 (see e.g. D. Kahneman and A. Tversky, *Prospect Theory: an Analysis on Decisions Under Risk*, *Econometrica*, 1979, 47, et al).

⁵ A more detailed analysis of the price rise over the last year in Estonia is found in Laura Ehrlich's article "Differences in Consumer Price Changes in the Baltic States Subsequent to the Accession to the European Union", and Andres Saarnit's article "Inflation in Immediate Past and Future", both published in the previous issue of *Kroon&Economy*.

because of tax rates. This is why there was a 2.3-time increase in the price of sugar in one month (April to May 2004) that received a lot of media coverage.

The income level in Estonia is relatively low in comparison to that of an average EU member country; therefore the share of motor fuel and food in the Estonian CPI basket is higher than elsewhere. However, a rise in the fuel excise, which resulted in a 17% increase in the motor fuel price in May, accounted for 1.1% of the rise in CPI, which totalled 2.1%. The share of fuel in the Estonian CPI basket is 6.56%. The share of sugar is smaller (merely 0.39%) and therefore out of the 129.3% price rise only 0.5 percentage points accounted for a growth in CPI. The price rise in other foods (bananas, some sorts of fish, etc) had a more modest role and its impact was below 0.2 percentage point of CPI.

Post-accession developments indicate that in last May there was a **one-off hike in prices** and that in June and July inflationary indicators measured against the previous month sank to their usual levels. However, it had no impact on perception of the price rise. One of the reasons is that residents' price rise expectations are based on past experience (see also Figure 2).

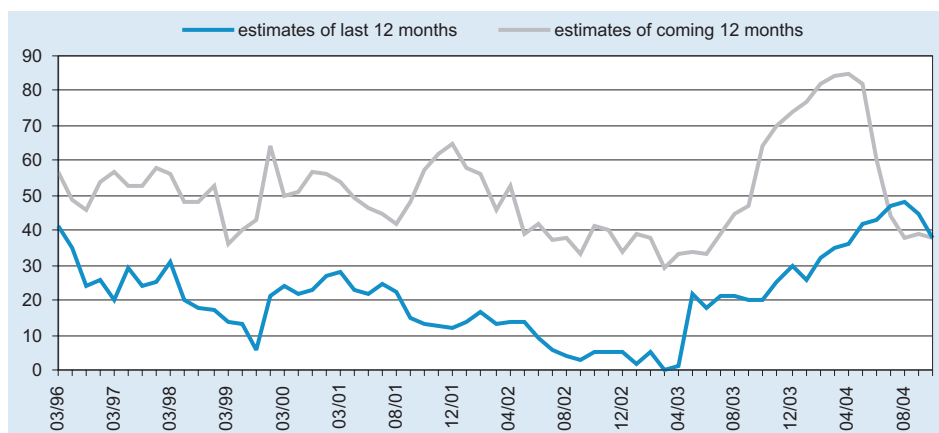


Figure 2. Consumers' estimates of inflation acceleration in the past and the future (balance of surveys, %)

Source: a survey of the Estonian Institute of Economic Research

Taxation policy and prices of goods and services of the non-tradable sector (more important prices being subject to price regulation) play a major role in shaping the price rise expectations in Estonia. Any rise in consumption taxes or state regulated prices is perceived as a sign of an accelerating price rise rather than a single step. For instance, from the autumn of 1999 to September 2001 the Estonian residents assessed the rise in consumer prices to be faster than it actually was. Obviously, it was related to a rise in the motor fuel excise duty in late 1999 and a rise in the electricity price in early 2001, which followed each other immediately. The hike in the fuel price in late spring and early summer of 2003 had a similar impact. Another reason is that in the light of a generally low inflation rate the news related to taxation policy and other measures in price rises receive media coverage.

■ Experience of the Current Euro Area in Perceiving ■ the Pace of Price Increase Before and After the Transition to the Euro

People's price rise perception differs from the objective indicator measured by the consumer price index, a phenomenon which is characteristic not only of Estonia. Distortions in the perception of price levels noted in Estonia after the accession are essentially fairly similar to estimates of price rises of the people in the "old" EU Member States after the transition to the euro cash in their respective home countries.

According to Eurostat's final report published in June 2003 the growth of euro area HICP amounted to 2.3% in 2002 when the transition to the euro was completed. Only 0.1–0.3 percentage points of that can be ascribed to the introduction of the euro. Inflation expectations (measured as a ratio of respondents expecting faster price rise and those expecting the price rise to slow down) rose, however, after the introduction of the euro in January 2003 to an unprecedented level in all euro area countries. Based on a survey of 20,000 respondents, the index of perceived inflation⁶ and movement of the actual HICP of the euro area were mostly simultaneous before the euro changeover in January 2002. Afterwards the gap has been strikingly wide over a long period. The gap has started to narrow only recently.

The difference between the inflation indicator perceived by the consumers of "old Europe" and the real indicator after the euro changeover may be first explained by psychological factors, i.e. in some categories of everyday goods and services essential for people (e.g. eating out, beer, hairdresser, dry cleaning) there was a clearly perceived price hike in the aftermath of the changeover. However, consumers hardly noticed a fall in the price of electronic goods or insurance services which reflect in the consumer price index⁷. EU analysts note that a majority of price rises receiving most attention are related to services that are paid for in cash or sectors where competition is rather low (local markets). A profound analysis by the Eurostat confirms that in case of such goods and services there is a correlation between the actual changes in prices and people's estimates⁸.

⁶ Indices of perceived inflation may only display the ratio of survey responses indicating more optimistic/pessimistic inflation assessment, the ratio of more optimistic/pessimistic assessments, or be a result of complicated calculations which take into account whether there was a price rise or a fall, how often the particular product or service is purchased and the product or service is paid for in cash, etc. Currently a fairly modern and sophisticated index is being worked out for the Federal Statistical Office of Germany (see H. W. Brachinger 2005).

⁷ CPI of the euro area actually grew by just 2.3% in 2002.

⁸ See e.g. the presentation of the director of the Directorate General for Economic and Financial Affairs of the European Commission Jan Host Schmidt at the conference "The Consumers and the Euro" in Brussels in March 2005 where he pointed out that most of the inflation in the year of euro changeover in the "old Europe" is explained by regular or one-off factors (a surge in some food prices because of animal epidemics or poor weather, oil price, etc). He stressed that there was some rise in the prices linked to the euro changeover but only in case of single groups of goods and services; unfortunately, people tend to incorrectly perceive the importance of components of the consumer basket. Therefore, transparency and targeted information campaigns are very important. At the same convention Jules Maaten, a Member of the European Parliament from Holland stated that in his country at least, the prices at restaurants were a focal point of the media and public opinion, that caused a fall in attendance and a lot of catering companies went bankrupt; also, several municipalities used the euro as "an excuse" to raise prices for public utilities.

It also depends on **how well residents of different countries were informed of the introduction of the euro**. Immediately before the euro changeover (in November 2001) the results of the public opinion poll Eurobarometer showed that of all the citizens of the future euro area the Finns were best informed (75% held they were well informed on the issues of the changeover) and the Greeks were the worst informed (only 42% thought they were well informed). The Finns perceived the rate of inflation after the changeover as the lowest while the Greeks' estimates were among the highest.

The EU Commissioner for Economic and Monetary Affairs **Joaquin Almunia's**⁹ urgent recommendation to the new countries joining the euro area is to very seriously prepare an information campaign targeted at the population. Recommendations of the European Commission on handling excessive fears of price hikes¹⁰, on the one hand, stress the need to **disseminate information**, especially from the viewpoint of the man in the street and, on the other hand, **increase confidence** in the euro.

■ What Could be Done Considering the Experience ■ of the Current Euro Area?

From the point of view of informing the general public the current European experience shows that the most important issue is providing information on the **exchange rate of the euro and the current national currency**, the euro **security features**, and **presentation of prices in euros and the national currency in parallel**. In the case prices will be presented in both euros and the old national currency during the transition, the new members are advised to consider a "strategy of leave" – in some euro area countries a display of parallel prices started in 2002 is still used, and seemingly, any commercial company fears to be the first to abolish the system.

Uncertainty and unawareness are certainly more harmful than unpleasant information on price advances actually taken place. Thus it is of utmost importance that the state and local municipalities along with consumer organisations conduct **systematic price monitoring**. Data on prices (price changes) should be collected long before the euro changeover in order to use a sufficiently detailed comparison basis for potentially "sensitive" prices. Another tool suggested is an information helpline people can call and report on unjustified price increases. Prompt publication of background mechanisms of the price rise and its actual indicators might help.

As regards Estonia we should evidently seriously consider a suggestion to pre-emptively implement a **"risk signal basket"** of goods and services which likely require closer monitoring; this is especially important in the case of goods purchased daily. **Jules Maaten**, a Dutch member of the European Parliament has said it should provide an opportunity to be "closer to people", that is, to speak of the price of beer or haircut rather than HICP. Experience of the current euro area and Eurostat analyses show that services

⁹ See e.g. "The Euro and Consumers: Three Years On", 14 March 2005.

¹⁰ See e.g. "The Effects of the Euro Changeover on Inflation", Brussels, March 2005.

where price changes most likely occurred during the euro changeover were restaurants, cafés, hairdresser's, various repair shops, entertainment, and culture and sport services. Presumably, the transition to the euro has, although less likely, had an impact on the price of some food (e.g. bread, fruits and vegetables, and beer), as well as cost of car servicing or accommodation.

The experience of the euro area today shows that in many cases “**codes of conduct**” were of help, when companies in certain sectors, members of professional associations etc agree on particular principles. The public sector should set an example here and firmly state they will follow common practice when converting prices of public services, taxes, and so on into euros. It should be noted, however, that a code of conduct is only useful when truly followed.

Codes of conduct in the present euro area countries did not always operate successfully. In a few countries at least the evaluation of consumer protection officials is rather negative¹¹: the companies which had joined the code frequently violated its terms because 1) small companies did not pay enough attention to the conditions; 2) there were no sanctions for violations; 3) the conditions were not disclosed; 4) no helplines for reporting violations or opened too late. Representatives of consumer protection associations of several EU members have suggested the new member states to attempt establishing compulsory price rules during the transition. How realistic it is to follow those recommendations will depend on the authority of local consumer protection organisations (and perhaps the entire third sector) and decisiveness, which is not necessarily high in the new member states.

It might be helpful in retail trade and personal services if companies following the code of conduct would receive the right to advertise themselves with **stickers confirming “fair price formation”**, which would presume existence of an institution that checks observation of the conditions, even if at random.

■ **Forthcoming Transition to the Euro and Price Developments in Estonia** ■

The euro changeover in Estonia will take place in the coming years and, most likely, our environment is more price sensitive in many ways (lower income strengthens the impact of price rises of some very volatile commodity groups such as food and fuel; our historic memory preserves experience of hyperinflation in the final decades of the Soviet period, to name a few factors). Therefore, it is especially important to avoid unsubstantiated price rise fears arising from ill-designed information campaigns or a failure to provide required information. It must be noted that fear of a price rise may be a pretext for an actual rise, that is fears might be selfishly used to substantiate decisions for actually unnecessary price rises.

¹¹ The code of conduct has been criticised by e.g. Italian consumer protection officials at international conventions.

To the question what disadvantages you see in relation to the transition, Estonians mostly say (if they point out any disadvantages at all) the **rise in prices**. There is no difference between the less affluent or wealthier people, or people with better or poorer education. People with better income and higher education point out the price rise as a risk in the euro changeover even more frequently¹², probably not because they would be more afraid of it but rather they are more readily willing to voice their opinion.

Reformulating the question and providing the respondents with a choice between options whether prices would rise faster upon the introduction of the euro than in Estonian kroons, whether they would rise slower than in the Estonian kroons, or whether the currency has no immediate connection with the price rise, the responses divide as follows:

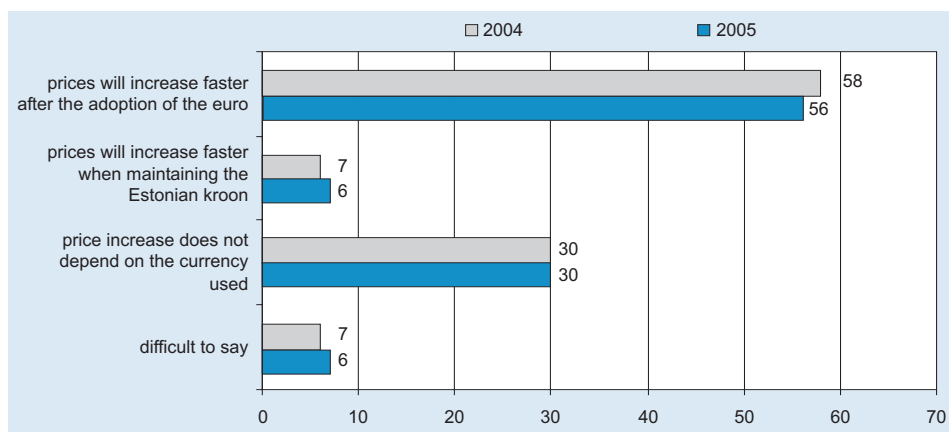


Figure 3. How will the prices change when the euro is introduced? (%)

Source: Saar Poll

Non-Estonians, the elderly, and people opposing the euro changeover tend to think that prices will rise faster when the euro is introduced. It might be assumed, thus, that the price rise is feared by those more conservative by nature or not very well informed, but according to the Faktum survey data 63% of the entrepreneurs and top managers and 61% of people with higher education also relate a steeper price rise and the changeover. Thus, even the groups who supposedly are more knowledgeable tend to stick to stereotypes. Once again, this reveals the importance of information dissemination and formation of attitudes.

Pupils tend to think that the price rise does not depend on the use of the kroon or the euro. Do we detect an impact of a modern systematic economic education provided in basic and upper secondary education that people with higher education obtained some decades ago just did not receive? It is more likely that pupils have no extensive purchasing experience, their structure of purchases differs from that of the adults, and they are more optimistic.

¹² Applies to both the Saar Poll and Faktum survey results.

The young also voiced stronger support to the European Union than the elderly, and here optimism and confidence in the future, which is characteristic to the youth, evidently had its say.

Again, Estonians are by no means exceptional in their fear of a price rise accompanying the transition, a rather similar attitude is dominant in the other new EU Member States as well.¹³ Economic and financial experts of the European Commission have noted that even if the results of the Eurobarometer survey in the new member countries look pessimistic, the situation in the present euro area countries before the transition to the euro was rather similar; the **attitudes towards the single currency only began to substantially improve when the introduction of the euro was almost tangible and practical information more easily obtainable.**

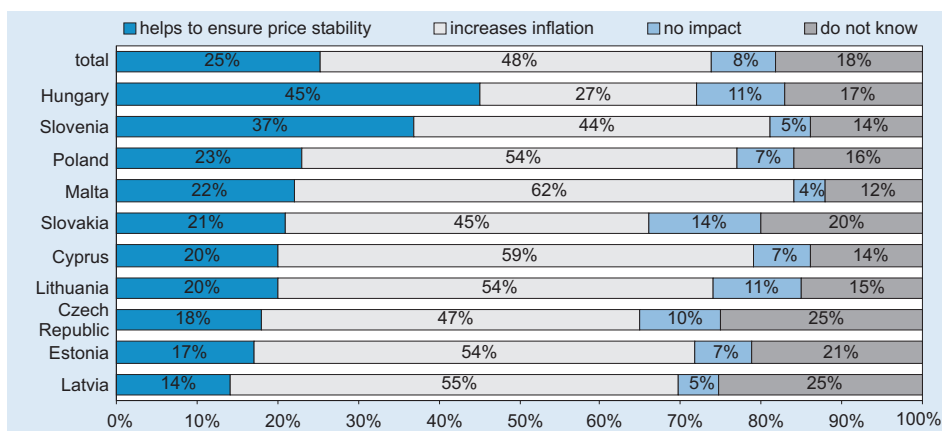


Figure 4. Fears of price rises related to the euro changeover in the new EU Member States

Source: Eurobarometer 2004

In conclusion, dissemination of information and education concerning price rise mechanisms and perception of the price rise must obviously be taken rather seriously in Estonia in the forthcoming years. Experiences and mistakes of other countries should be learned from. Taking into consideration the Estonian situation and people's mindset, a remark by **Jim Murray**¹⁴, the head of the European Consumers' Organisation should receive serious attention. He mentioned that even though the euro changeover was generally successful, problems were caused by some politicians' desire to ignore the current issues and also by some "over-selling" which resulted in a perfectly normal counter-reaction among less euro-enthusiastic people. The possible impact the transition to the euro might have had on inflation was admitted too late. People's over-reaction may also have had a few reasons: on the one hand, price changes of single everyday

¹³ See e.g. the Eurobarometer survey "Introduction of the Euro in the New Member States", http://www.europa.eu.int/comm/public_opinion/flash/flash165b_en.pdf.

¹⁴ Conference "Consumers and Euro", 2005.

services and goods were more noticeable, as the impact of the changeover was also more obviously manifest. On the other hand, normal inflation was also observed to a greater extent. In the case of associating inflation with the euro changeover one should always ask what the situation would have been like if the euro had not been introduced. It is not quite correct to still compare the prices against the 2001 level. **A combined impact of various reasons has made the euro into a scapegoat in some parts of the “old Europe”; the euro is now blamed for economic difficulties and failures. Another feature is following others’ example – blaming the euro is “fashionable” and Estonians, as a rule, are rather trend-conscious.**

Actually, the euro’s role has been remarkable in securing the price stability over the last few years. For instance, the oil price shock of 1999 was of a similar extent that it was in the 1970s but its impact on price indices was much smaller thanks to the euro. The European Central Bank has all necessary instruments and independence to fulfil its function; disclosure of the European Central Bank’s strategy and especially its clear numerical target (close to 2% but not over it) have contributed to the formation of expectations. When observing the worldwide impact of the introduction of the euro, it has been clearly positive for the consumers, especially considering the joint impact of present lower interest rates and low inflation. But this is yet another topic.