Price Level Convergence and Inflation in Europe

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Abstract

Consumer price inflation in the euro area declined steadily during most of the 1990s. However, in the last two years, both headline and core inflation have risen throughout the area, and sizable cross-country differences in inflation have re-emerged. This is illustrated by Figure 1, which shows the headline consumer price inflation rate for the euro area as a whole and for select member countries. As of October 2000, all euro area countries had headline inflation rates above the European Central Bank's 2 percent medium-term ceiling, with rates ranging from 2.1 percent in France and Austria to 6 percent in Ireland. In Greece, which will join the euro area on 1 January 2001, inflation was 3.8 percent. One factor, discussed prominently in policymaking circles, that may be contributing to cross-country differences in inflation is price level convergence or "inflation catch-up".

According to the argument, if prices expressed in a common currency are initially different across countries, convergence to a common level of prices implies higher inflation in countries where prices are initially low. There are several reasons to expect at least some price convergence in Europe. Progress toward a single market, including already completed trade liberalization and adoption of the single currency, should narrow differences in common-currency prices across countries, at least for traded goods. To the extent that the currency conversion rates chosen at the launch of the euro did not equate price levels across the euro area, scope remained for further price convergence after January 1999. The Balassa-Samuelson hypothesis provides another explanation why prices of nontraded goods might rise faster in poorer European countries.

Suppose that poor countries are initially low-price countries, and that economic integration creates pressure for European-wide convergence of productivity levels in making traded goods. In addition, suppose that productivity levels in making nontraded goods converge at a much slower rate, if at all. Under these assumptions, poor countries will find that their productivity growth is concentrated in the traded goods sector. The rise in output and wages in the traded goods sector that would result from a European-wide convergence of productivity, would then push up wages and hence prices in the nontraded goods sector of the poor countries, compared to the wealthier, high-price countries.

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