

PRICE CONVERGENCE IN THE EU

Currently, Commission services are measuring price convergence using Eurostat's Purchasing Power Parities (PPP)¹ for private household consumption. The underlying database is an official data set with an elaborated methodology that has been carefully improved over the years.² The ultimate objective of producing PPP data is to obtain comparable volumes of GDP across countries that are free of price level distortions.

While the quality of the PPP data set serves perfectly this very specific purpose, the question arises as to what extent the data set underlying the Eurostat PPP exercise can be used to improve the measure of price convergence in the Internal Market; price convergence which can be expected according to the law of one price. Indeed, from an economic point of view, in an integrated market, the price of a given good should not differ significantly depending on the geographic location of the good, beyond what can be expected due to transport cost, tax differences and other factors discussed in previous publications³. Checking for price convergence in this sense requires checking for convergence not just in the overall price level but also in prices of individual goods and services.

However, not all goods and services that consumers buy – and which are integrated in the PPP data set – can be expected to converge equally as a result of integration. For example, the current indicator includes consumer spending in housing. As rents paid for housing on average account for a considerable share of total consumption expenditure, they accordingly receive a substantial weight in the PPP data set. But, price convergence in housing can not necessarily be expected in the same way as price convergence in tradable goods. Better integration of markets which facilitates free movement of goods and services will not affect rent-driven prices, which depend more on location factors. This raises the question of which goods and services should actually be included in the measurement of price dispersion in the Internal Market. The Commission is therefore considering the possibility of focusing on one type of products only, by excluding goods and services that are less or not tradable.

With the experimental analysis presented in the Internal Market Scoreboard in July 2005, the Directorate General Internal Market is exploring to what extent the distinction between these groups of products is relevant to explain the evolution of price dispersion. This has been the purpose of this exercise which is based on a first, non-official and provisional classification of goods according to their “tradability”. A definitive list of

¹ The structural indicator refers to goods and services purchased by private households only.

² The methodology of calculating purchasing power parities is described in detail in the joint Eurostat-OECD Manual.

³ See for instance the Cardiff Report 2001 (available for download at http://europa.eu.int/comm/internal_market/en/update/economicreform/cardiff02en.pdf), or the publication by ECFIN, “European Economy – Supplement A of July 2001 (download at http://europa.eu.int/comm/economy_finance/publications/european_economy/2001/a2001_07_en.pdf)

product groups considered as tradable will be decided upon only after agreement between all Commission services involved.

Another issue that will be further analyzed is the product to product comparability in the underlying data set. The products chosen for the PPP surveys are comparable between countries to the extent that they are representative for consumption in each individual country and representative for the price level of the product group they belong to. However, the baskets priced by different countries do not include exactly the same goods in all cases. For instance, if Nordic countries use sunflower oil, and olive oil is more often used in Mediterranean countries, these goods cannot be treated in the same way for these countries. The PPP methodology applies an elaborated mechanism to control for differences in preferences across countries. While this approach is one of the strengths and very cost efficient when measuring Purchasing Power Parities, it can be more problematic when trying to measure price dispersion at product level. This is another issue that will require further consideration, allowing for the limitations of the PPP data set for this purpose.

The analysis presented in this Scoreboard is therefore an exercise to explore to what extent the measurement of the evolution of price convergence is sensitive to these factors. Consequently, the interpretation of the results has to be considered in the view of the nature of this exercise, i.e. experimental, and therefore, provisional. In addition, while we consider the development of price differences in general as an appropriate measure for better market integration, it has to be stressed that market integration should not be assessed on this basis alone. Further indicators are e.g. the implementation deficit of Internal Market directives, the number of infringements, the volume of intra-EU trade and FDI.

Furthermore, based on the current data set, we can only state whether we observe price convergence (or an increase in dispersion, respectively) or not. As the current data set does not provide absolute price levels, it is more difficult to determine the direction of the convergence: Do prices go up, or do they converge to the lower end? These issues deserve further in depth analysis in the future.

Finally, the analysis of price dispersion should be followed at a later stage by an explicit analysis of the reasons for price dispersion.