

Box 2

Recent developments in consumers' inflation perceptions

Survey evidence suggests that, over the past two years, consumers have perceived inflation as being higher than it has been in reality. Most notably, in the first half of 2002, overall HICP inflation declined from 2.7% in January to 1.7% in June (Eurostat's flash estimate), while consumers appeared to have the impression that price increases had been rising. Such a situation could be a cause for concern if it persists. If consumers overestimate current price developments, they may be underestimating developments in their real wages and thereby also their purchasing power. This might, for instance, lead to misguided wage demands and sub-optimal consumption decisions. This box starts by presenting an indicator of perceived inflation obtained from the European Commission Consumer Survey (EC survey). Following on from this, recent developments are assessed –with a special focus on possible explanations for the divergence between perceived and actual inflation, as has been observed since mid-2000.

An indicator of perceived inflation

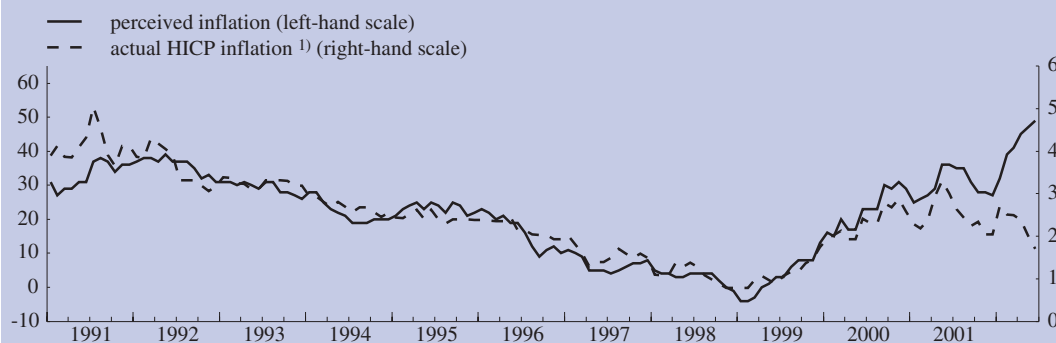
Two questions related to price developments in the euro area are asked in the EC survey. The first question covers consumers' expectations as regards price developments one year ahead, whereas the second concerns their perceptions of price developments over the previous twelve-month period. The EC survey is conducted at a national level on a monthly basis. The participants –approximately 26,000 consumers –are all asked the following question regarding their perceptions of current inflation: “Compared with what it was twelve months ago, do you think the cost of living is now: (i) very much higher, (ii) quite a bit higher, (iii) a little higher, (iv) about the same, (v) lower or (vi) don't know?” The survey results are summarised by the European Commission in the form of a “balance statistic”, computed as the difference (in percentage points) between the proportion of respondents stating that the cost of living was higher and the proportion of respondents stating that the cost of living was lower or unchanged. It should be noted, however, that this measure provides qualitative information on the perceived direction of the change in inflation, and not the actual, quantitative, rate of inflation.

Although actual HICP inflation declined in the first half of 2002, consumers perceived inflation as increasing

The chart depicts consumers' inflation perceptions together with actual HICP inflation from January 1991 to June 2002. It appears that consumers captured actual price developments quite well in their assessment of past inflation developments over most of this period. However, since mid-2000 the evolution of the perceived

Consumers' inflation perceptions and actual HICP inflation

(percentage balances; annual percentage changes; monthly data)



Sources: European Commission Business and Consumer Surveys and Eurostat.

1) Data up to December 1994 are estimates based on national CPIs.

inflation indicator has not been consistent with actual developments in the euro area HICP. Notably, this inconsistency has increased further in the course of 2002, reflecting, on the one hand, the slowdown of actual inflation and, on the other hand, a further increase in the indicator of perceived inflation.

The most plausible explanation behind the divergent developments in actual and perceived inflation over the past two years is that – in completing the survey – consumers attach a very large weight to price developments in the goods and services they buy more frequently (such as food, petrol, etc.). If price developments in these frequently purchased items differ significantly from price developments in products purchased less frequently (such as cars, refrigerators, cameras, etc.), the consequence is that consumers form an unrepresentative picture of the broad consumption basket – from which the HICP weights are derived – and thereby also of the price movements at an aggregate level.

The above explanation finds support if recent actual price developments are scrutinised. Euro area inflation has been hit by a number of adverse price shocks since 1999 (see the box entitled “The clustering of shocks to HICP inflation since the start of Stage Three of EMU” in the June 2002 issue of the Monthly Bulletin). Reflecting the energy price shock in 1999 and most of 2000 (which was reinforced by the depreciation of the euro exchange rate), the annual rate of change in petrol prices increased from -6.1% in December 1998 to 23.8% in March 2000 – in line with the increase in oil prices, which rose from €8.8 to €28.2 per barrel over the same period. Moreover, in 2000 the price of meat started to increase as a result of the health concerns related to cases of BSE in a number of euro area countries. The outbreak of foot-and-mouth disease in some countries and the measures taken in order to prevent a further spread of the disease generated further upward pressures on food prices. In fact, from January to May 2001, when the annual inflation rate peaked at 3.3%, unprocessed food prices were the main factor behind the increase. In the latter half of 2001, when the shock to meat prices began to unwind, unfavourable weather conditions started to exert upward pressures on vegetable prices. In January 2002, vegetable prices were almost 20% higher than they were one year earlier. As regards the euro cash changeover, there is no hard evidence at the aggregate level of any significant price effect. However, prices of certain services, such as restaurants, hairdressing and dry cleaning, rose more than usual during the first half of 2002, which may be related to the introduction of the euro banknotes and coins. For instance, in January 2002 the month-on-month price increase for restaurant services was three times higher (at 1.3%) than the average increase in this month during the period 1996-2001 (0.4%). Stronger than usual price rises in some of these items continued at least until May 2002.

Petrol, meat, vegetables and restaurant services are all good examples of items that are purchased more frequently and, hence, their price developments may be viewed as being particularly important by consumers when they assess developments in inflation. In the light of recent price increases in those items, it is clear why consumers perceived inflation as being higher than it actually was over the last two-year period. Unless new price shocks occur, consumers’ perceptions as regards current price developments should decline again to become more in line with developments in actual inflation. Such convergence is crucial, since it would help prevent consumers from wrongly assessing, for instance, their real wage developments.