EUROPEAN CENTRAL BANK

EUROSYSTEM

Price stability: why is it important for you?

Pupils' information leaflet

What can you buy for € 10? How about two CD singles, or maybe even a copy of your favourite magazine every week for a month?

But have you ever thought how this is possible? How come you can exchange a piece of paper for a product or a service? After all, the banknote itself actually costs only a few cent to produce.

Trust is valuable

So why is this piece of paper worth so much? It's simply a matter of trust. If your best friend borrows € 10 from you, you know that he or she will pay you back. With a stable currency like the euro, you can also be sure that you will always be able to buy goods and services that are worth as much as the value printed on the banknote. However, if your money were to decline substantially in value, then you would lose confidence in it. Money is valuable because people trust it.

Money makes more sense than swapping things

Let's suppose, for a moment, that money didn't exist. People would have to buy and sell by bartering.

If your baker wanted to get a haircut in exchange for five loaves of bread, he would first have to find a barber who would be willing to accept those five loaves of bread in exchange. And if the barber then wanted a pair of shoes, he would have to find a shoe-shop owner who wanted to exchange his bread for shoes.

We would all have to find someone who wanted what we had to offer and was able to offer us what we wanted in return. And even if we did find that person, we would still have to decide on the right exchange ratio for bread versus haircuts, haircuts versus shoes, etc.

Money simplifies life in three ways. Firstly, it is a medium of exchange – you no longer have to match needs or demands as in a barter economy. Secondly, money is a unit of account – prices are quoted in monetary units only, and not in terms of goods or services. And, finally, money is a way of "storing value" – people can save it so that they can buy things in the future.

Price stability and the value of your money

Price stability is when your money retains its value over time. This is important if you want to save your money to buy something later, for example. Imagine how you would feel if you had saved € 10 to buy two CD singles, only to find that the price had risen to € 12 when you got to the shop. Then, when you went back with € 12, the price had gone up to € 14. Fortunately, prices don't usually rise that quickly (see inflation table on pages 14 and 15).

How price changes are measured

Consumer price indices – which we use to check price stability – are compiled once a month using what is called a "shopping basket". This basket contains a broad range of products which are typically consumed by a representative household. The total price of the "shopping basket", as a measure of the general price level, is then periodically checked to see how much prices are rising (or, in rare cases, falling).

Inflation, deflation and price stability

Inflation is an increase in the general price level. In simple terms, inflation can arise when there is too much money chasing too few goods. Prices may increase for different reasons. For example, suppose there is only one CD left in the shop and you and all your friends want to buy it. The shopkeeper will probably increase the price of the CD because he knows that demand is high and he can get more money for it.

Similarly, a product may become more expensive if it costs more to produce it. If energy prices go up, for example, then the costs of producing your CD will also go up and the manufacturer will increase its wholesale price in order to avoid making a loss. For the same reason, the shopkeeper will attempt to pass this price increase on to you.

In both examples, your €10 has lost some of its value, or its "purchasing power", because it is no longer enough to buy two CD singles. However, we can only speak of inflation if this were to happen to the total price of the whole range of products included in the "shopping basket", and not just to one item.

Deflation can be defined as the opposite of inflation, or as a situation where the general price level falls over time. It may result from low demand for goods and services, which forces companies to sell their products at cheaper prices.

Prices are said to be stable if, on average, they neither increase (as in periods of inflation) nor decrease (as in periods of deflation) over time. If, for example, €50 can buy roughly the same "shopping basket" as it could one or two years previously, then we can say that the general price level is stable.

Price stability promotes economic growth and employment …

- ***… by making it easier to compare prices***

Stable prices make it easier to compare prices and therefore to decide which goods or services to buy.

When prices are stable, you can easily tell if the price of the trendiest jeans has increased compared with the price of the latest trainers. This means that you as a consumer can make better decisions on what to buy with your money.

In the same way, companies can make well-informed investment decisions. Resources can then be allocated in the most productive manner and the productive potential of the economy will increase.

With inflation (or deflation) the prices of all goods change significantly and frequently and in an unpredictable manner. As a result, it is difficult to judge whether the change in the price of a product makes it cheaper or more expensive in relation to other products. Consequently, companies and consumers may misinterpret price changes and make mistakes in their purchasing decisions. This then leads to an unproductive use of resources.

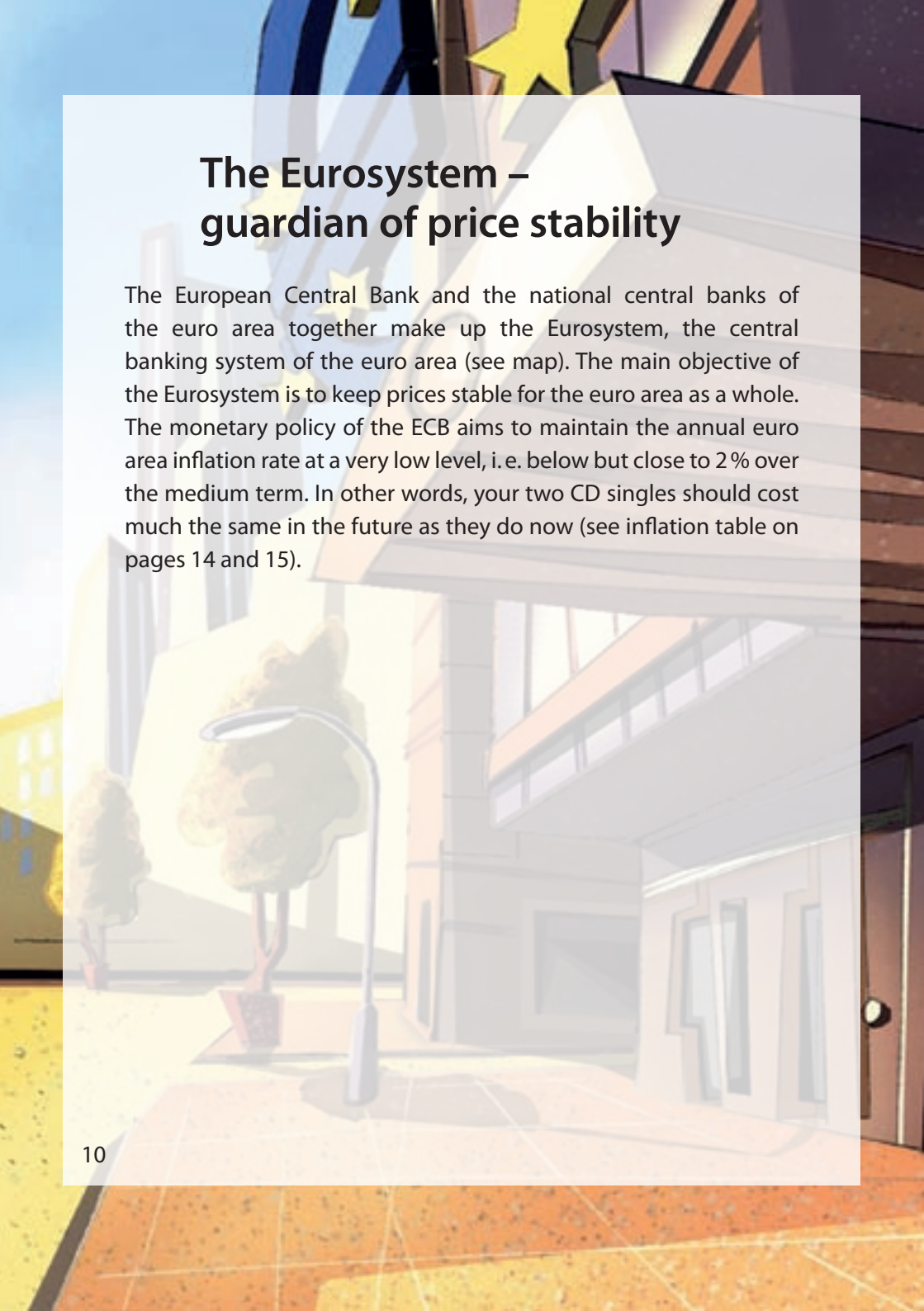
- ***… by reducing the cost of borrowing money***

When prices are stable, savers and lenders are prepared to accept lower interest rates on their savings because they expect the value of their money to stay the same over longer periods of time. Otherwise, they would want some insurance against the uncertainty surrounding the future value of their money and request a higher rate of interest when depositing or lending it.

As a result, borrowers can benefit from lower interest rates. This means lower borrowing costs for companies that want to buy more modern machinery and for people who want a loan in order to buy a car or a house, for example. Encouraging companies to invest in this way helps to improve their competitiveness and creates extra jobs. This is another reason why stable prices are such an important contribution to economic growth and employment.

The social aspects of price stability

Price stability is key to social stability, too. In an inflationary environment prices tend to change in an unpredictable way, which may cause considerable losses to people. For example, inflation can reduce the value of people's savings. Typically, the poorest groups of society often suffer the most from inflation, as they have only limited possibilities to protect themselves. Throughout history, high rates of inflation (or deflation) have often created social instability.



The Eurosystem – guardian of price stability

The European Central Bank and the national central banks of the euro area together make up the Eurosystem, the central banking system of the euro area (see map). The main objective of the Eurosystem is to keep prices stable for the euro area as a whole. The monetary policy of the ECB aims to maintain the annual euro area inflation rate at a very low level, i. e. below but close to 2 % over the medium term. In other words, your two CD singles should cost much the same in the future as they do now (see inflation table on pages 14 and 15).

Euro area


Euro area
In 2011 the euro area comprises Belgium, Germany, Estonia, Ireland, Greece, Spain, France, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia, Slovakia and Finland.
EU Member States with a special status
EU Member States that have not yet adopted the euro
Sweden
Finland
Helsinki
Tallinn
Estonia
Stockholm
Latvia
Riga
Lithuania
Vilnius
Denmark
Copenhagen
Dublin
Ireland
United Kingdom
London
Nether-lands
Amsterdam
Berlin
Warsaw
Poland
Brussels
Germany
Belgium
Luxembourg
Luxembourg
Prague
Czech Republic
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Austria
Hungary
France
Slovenia
Ljubljana
Romania
Bucharest
Bulgaria
Sofia
Italy
Rome
Portugal
Lisbon
Madrid
Spain
Greece
Athens
Nicosia
Cyprus
Valletta
Malta
Madeira (PT)
Canary Islands (ES)
Azores (PT)
French Guiana (FR)
Guadeloupe (FR)
Martinique (FR)
Réunion (FR)
Status as of 2011

Glossary

Barter: the mutual exchange of goods and services without using money as a medium of exchange. It can only take place when there is a mutual need for the items being traded.

Consumer Price Index: compiled once a month using what is called a "shopping basket". For the euro area, the Harmonised Index of Consumer Prices (HICP) is used, with a statistical methodology that has been harmonised across countries.

Deflation: a decline in the general price level, e.g. in the consumer price index.

Euro area: the area that is made up of those Member States of the European Union in which the euro has been adopted as the single currency.

European Central Bank (ECB): established on 1 June 1998 and located in Frankfurt am Main, Germany. The ECB is at the heart of the Eurosystem.

European System of Central Banks (ESCB): the ECB and the national central banks of all EU Member States, regardless of whether or not they have adopted the euro.

Eurosystem: the ECB and the national central banks of those Member States that have already adopted the euro.

Inflation: an increase in the general price level, e. g. in the consumer price index.

Interest rate: the percentage of extra money you get if you lend your money to someone else (or keep it in the bank) or the percentage of extra money you have to pay if you borrow money.

Price stability: maintaining price stability is the primary objective of the Eurosystem. The Governing Council of the ECB, the supreme decision-making body of the ECB, has defined price stability as a year-on-year increase in the HICP for the euro area of below 2 %. It has further clarified that within this definition it aims to maintain the annual inflation rate at below but close to 2 % over the medium term.

Inflation table

1. The impact of inflation on the price of two CD singles costing € 10 today (after *n* years)

Annual inflation rate:	1%	2%	5%	10%	30%
	Stable prices		Inflationary environment		
1 year later	10.10	10.20	10.50	11.00	13.00
2 years later	10.20	10.40	11.03	12.10	16.90
3 years later	10.30	10.61	11.58	13.31	21.97
4 years later	10.41	10.82	12.16	14.64	28.56
5 years later	10.51	11.04	12.76	16.11	37.13
6 years later	10.62	11.26	13.40	17.72	48.27
7 years later	10.72	11.49	14.07	19.49	62.75
8 years later	10.83	11.72	14.77	21.44	81.57
9 years later	10.94	11.95	15.51	23.58	106.04
10 years later	11.05	12.19	16.29	25.94	137.86

2. The impact of inflation on the purchasing power of money

(base year = 100, after *n* years at a given inflation rate, as a percentage)

Annual inflation rate:	1%	2%	5%	10%	30%
	Stable prices		Inflationary environment		
1 year later	99.0	98.0	95.2	90.9	76.9
2 years later	98.0	96.1	90.7	82.6	59.2
3 years later	97.1	94.2	86.4	75.1	45.5
4 years later	96.1	92.4	82.3	68.3	35.0
5 years later	95.1	90.6	78.4	62.1	26.9
6 years later	94.2	88.8	74.6	56.4	20.7
7 years later	93.3	87.1	71.1	51.3	15.9
8 years later	92.3	85.3	67.7	46.7	12.3
9 years later	91.4	83.7	64.5	42.4	9.4
10 years later	90.5	82.0	61.4	38.6	7.3

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