The most expensive country in the euro area

18 Dec 2015 – Analysis – Finnish economy

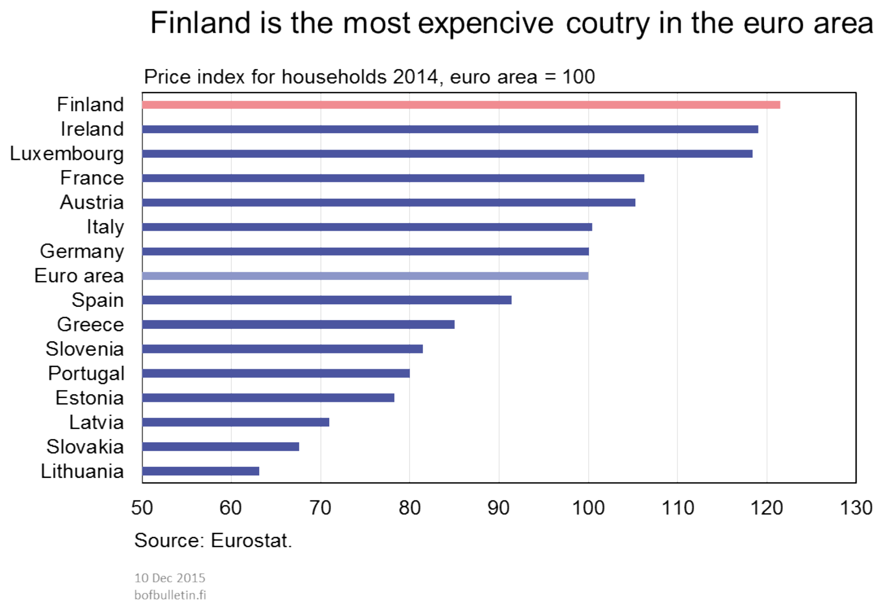
In the years since the financial crisis and up until recent months, domestic consumer prices have risen at a higher pace than in the euro area, and Finland is currently the most expensive country in the euro area as measured by consumer prices. The elevated price level erodes consumers' purchasing power, while the rapid increase in prices weakens the cost-competitiveness of Finnish export industries. Compared with the rest of the euro area, the price rise has been particularly rapid for commodities with large components of labour costs and indirect taxes.

Finns pay more

Between 2007 and 2015, the Harmonised Index of Consumer Prices (HICP) has risen 15% in the euro area, against 20% in Finland. This implies a further increase in the domestic price level, which was high to begin with. In 2014, an average Finnish household paid EUR 121 for a basket of goods that could be bought for EUR 100, on average, in the euro area.

The relationship between consumer prices and the competitiveness problem is demonstrated by the fact that in order to achieve the same purchasing power as in the euro area, the nominal wage of a Finnish employee must be 21% above the average for the euro area.

Chart 1



This article explores developments in consumer prices by commodity group and examines why consumer prices have risen faster in Finland than in the euro area. Of the commodity groups, services prices, in particular, have posted higher growth in Finland than in the whole of the euro area (Chart 1). The share of services in HICP is 41%. Similarly, consumer prices for food (22% of HICP) and energy (8% of HICP) have risen faster in Finland than in the euro area. Only have the prices of industrially manufactured consumer goods (29% of HICP) risen more slowly in Finland than in the euro area (Chart 2).

The analysis shows a rapid increase, in particular, in the prices of commodities with a large labour cost component. The increases in indirect taxes introduced in Finland in recent years have also fuelled inflation more than in the euro area on average (Chart 3). Furthermore, the elevated price level in Finland is often attributed to the low level of competition in the closed-sector industries. However, the rise in domestic prices of some commodities appears to have been dampened by changes in market structures, which have increased the competition.

Chart 2

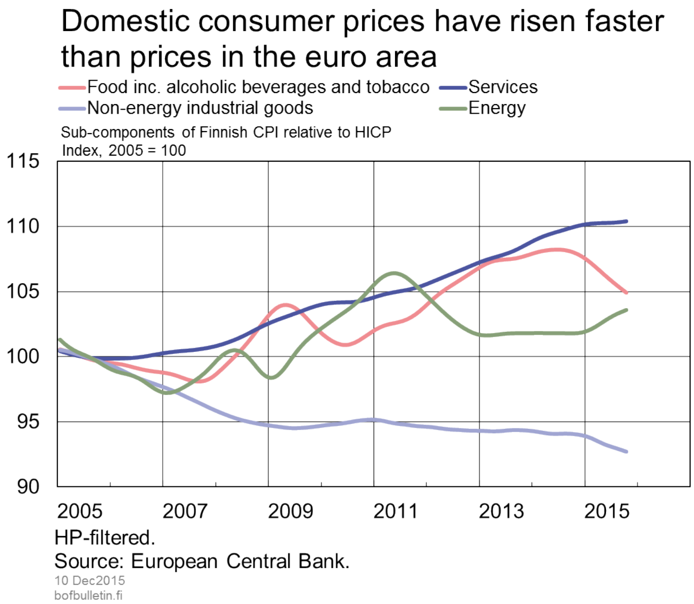
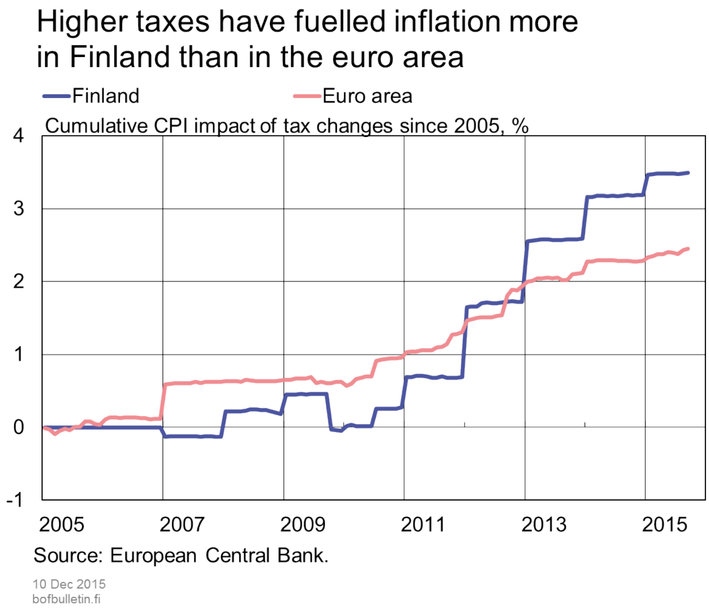


Chart 3



Taxes and wages have lifted food prices

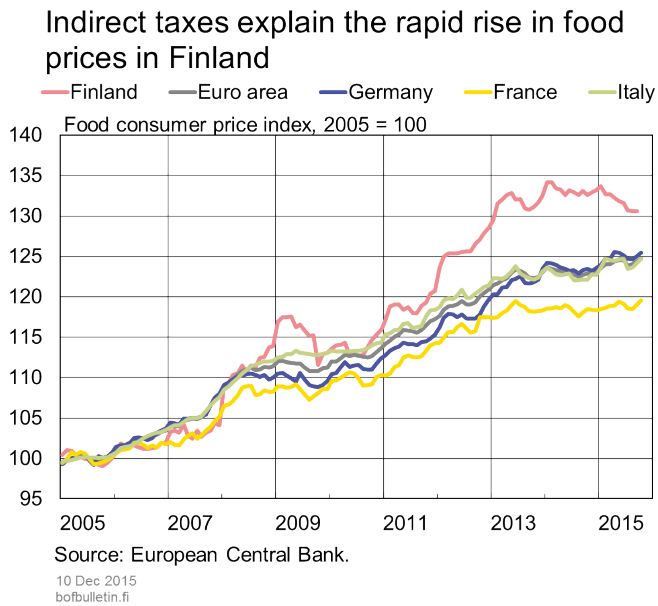
Food prices began to decline in Finland soon after Finland's accession to the EU, moving closer to the European level of prices. However, the decline was temporary, and real food prices have trended up again since the turn of the millennium, with food prices approaching pre-accession levels.[1]

In 2007–2015, in particular, the rate of increase in food prices in Finland has been

1. Statistics Finland (2014).

clearly higher on average than in the whole euro area. However, early in the period, in 2007–2009, the rise in food prices was, temporarily, more subdued in Finland than in the euro area. (Chart 4).

Chart 4



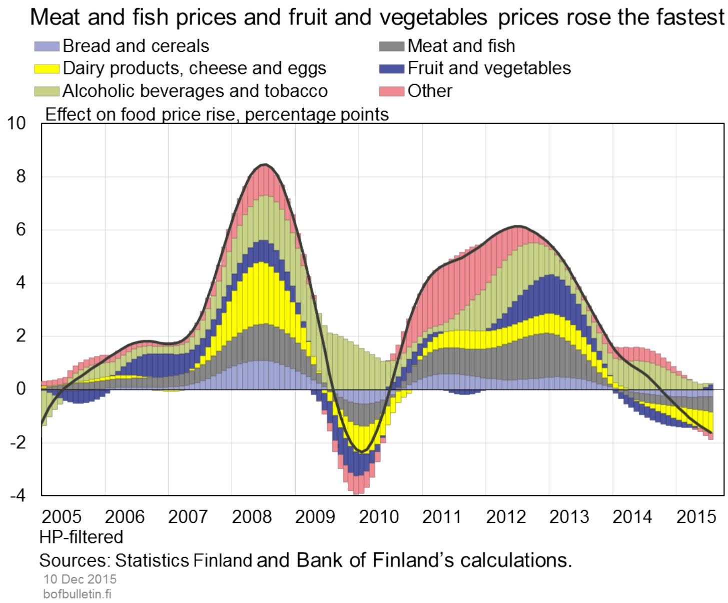
In the run-up to the financial crisis, world market prices of food rose swiftly, but the impact on Finnish consumer prices came later than in the rest of the euro area. Whereas the increase in world market prices typically fed through gradually into consumer prices in other euro area countries, Finland experienced a leap in prices in early 2008. The non-synchronous transmission of world market prices mainly reflects the longer cycles of price agreements between industry and trade in Finland compared with the rest of the euro area. In October 2009, the value-added tax on food in Finland was cut from 17% to 12%, and increased to 13% one year later. The cut in the value-added tax largely passed through to consumer prices, which temporarily effected a marked slowing of the rise in food prices.

But since 2009, food prices in Finland have risen faster than elsewhere in the euro area, up until last year when the price reduction campaigns of the central food chains began to work their way into food prices. The reduction in agricultural producer prices in 2014 helped pave the way for the food price campaign. However, by the central food chains' own account, the campaigns have been financed partly by profit margins.

Of food prices, the prices of meat and fish and fruit and vegetables (Chart 5) rose most rapidly in 2010–2013. The prices of alcoholic beverages and tobacco have risen faster than elsewhere in the euro area, due to higher alcohol and tobacco taxes, while the introduction of a tax on soft drinks has markedly driven up the prices of non-alcoholic beverages. Overall, the net effect of tax changes on food prices has been around 8% in 2009–2015.

Another factor behind the difference in the food price rise, in addition to tax changes, is the higher rate of increase in wages compared with the rest of the euro area. In addition, there are some signs of higher margins being charged within the food production chain, i.e. by producers, industry and stores. In a joint project, the Pellervo Economic Research Institute (PTT) and the Natural Resources Institute Finland explored developments in the margins of producers, industry and stores in the production chains of meat, cereals, vegetables and fruit. They found a significant rise in the stores' share in cash flows related to food sales in 2008–2012.[2] The negotiating power of the food retailer sector within the production chain lies in the high degree of store-chain concentration. In 2014, the S Group and K Group held a combined market share of nearly 80% of aggregate sales of daily consumables.

Chart 5



Energy price advantage over euro area lost

In Finland and the euro area alike, consumer energy prices have outpaced inflation since the turn of the millennium. In the first few years of the new millennium, the rise in the price of energy was slower in Finland than in the euro area, the rate of increases for Finland being 37% and that for the euro area 47%.

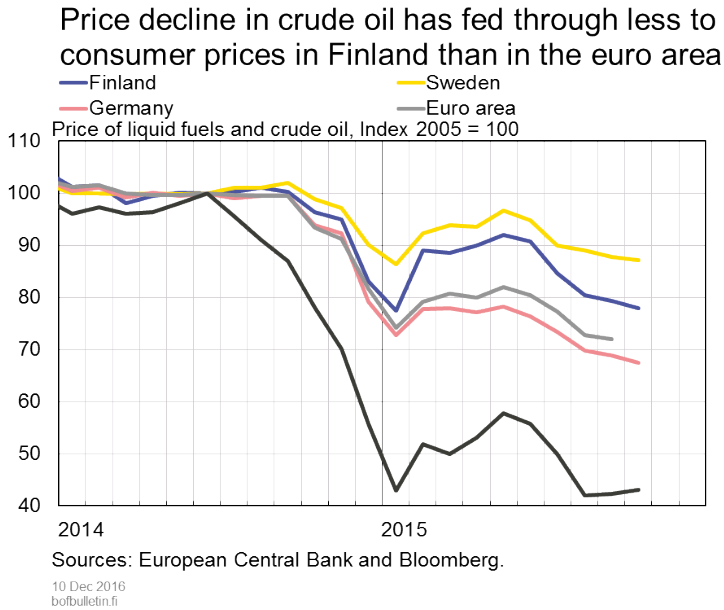
Since 2007, domestic energy prices have risen faster than euro area prices, and the price advantage gained early in the millennium has faded away. The faster rise in energy prices mainly reflects higher taxes on energy. Since 2007, tax increases have accounted for 15% of the price of energy in Finland, compared with 6% in the euro area.

In June 2014, world market prices of crude oil began to drop, and the price of Brent oil was halved by January 2015 (Chart 6). Since June 2014, consumer fuel prices have declined 28% in the euro area and 21% in Finland. The decline in consumer prices has not been as steep as in world market prices, considering that excises and VAT, as well as the margins of e.g. service stations and the oil refining process, are also built into

2. Peltoniemi et al. (2014a), (2014b) and (2015).

consumer prices.

Chart 6

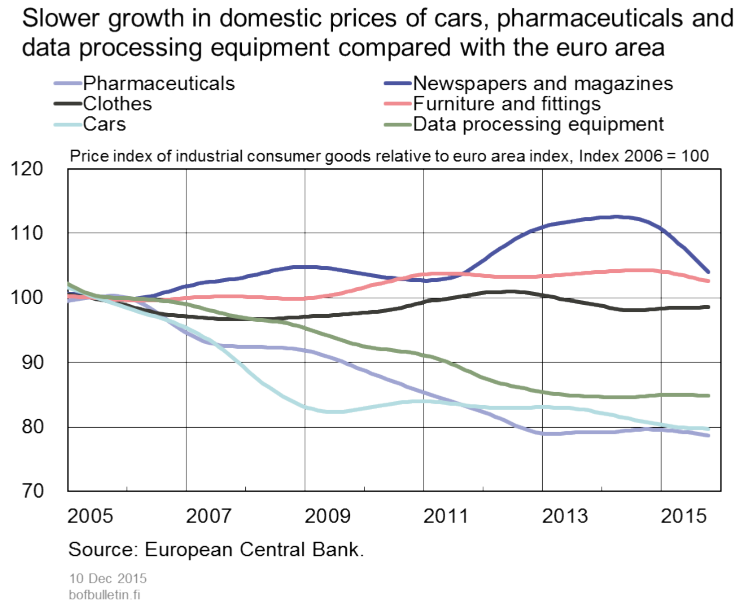


Taxation explains only part of the national differences in the pass-through of the oil price shock to consumer prices, given the harmonisation of fuel taxes in EU. In the old Member States, taxes account for around two-thirds of consumer prices on petrol and diesel, and differences in national tax rates represent only a couple of percentage points.

Slower increase in industrial goods prices in Finland than in the euro area

Prices of industrially manufactured consumer goods, excluding energy, have risen at a slower rate in Finland than in the euro area. In the new millennium, the rate of increase in the prices of industrial goods (excl. energy) has been only 1% in Finland, against 11% in the euro area. In Finland, the prices of pharmaceuticals, cars and electronics, in particular, have posted more subdued growth, whereas developments in the prices of clothes, furniture and fittings, newspapers and magazines and household appliances have been broadly similar in Finland and the euro area. (Chart 7).

Chart 7



Given the strict regulation of the pharmaceutical market and the high publicly reimbursable share of prescription drugs, policy changes exert a major influence on the prices of pharmaceuticals. The favourable price developments compared with the euro area are partly related to the reforms of the pharmaceutical market in the new millennium. In April 2003, Finland introduced a drug substitution scheme, where the pharmacies are allowed to substitute for a drug prescribed by a doctor a less expensive one containing the same active substance, unless this has been expressly forbidden by the doctor or customer. In 2009, this scheme was complemented by a drug reference price system, where a reference price is used as a ceiling for the reimbursement payable by the Social Insurance Institution (Kela). Since 2005, the prices of pharmaceuticals have fallen by around 15%.

Tax changes are also largely responsible for developments in car prices. Car prices have declined in step with used car imports and internet car sales, which began to gain ground in the new millennium, stimulating price competition. Taxes on imported private cars were reduced in 2003, which boosted car imports. In 2008, the car tax scheme for first-time registration of motor vehicles was replaced by an emission-based scheme, which shifted the focus of taxation from the purchase to the use of cars. Since 2009, VAT is no longer built into the car tax, which reduced prices further.[3] The motor vehicle tax annually charged for the use of a car is a component of the national consumer price index but not of HICP, which is analysed here.

Consumer prices for electronics have declined rapidly across the board. The price decline largely mirrors the rapid pace of quality improvements in electronics, which is reflected in a drop in the price index. Domestic electronics prices have fallen faster than euro area prices, which is probably partly attributable to differences in the quality adjustment methods of euro area countries. The steep decline is also related to the increase in

3. VTV (2009).

internet trade and the ease of price comparison, which has driven price competition.

Direct tax effects do not fully account for the slower rate of increse in industrial goods witnessed in Finland as compared with the euro area, as reductions in individual commodity taxes have been offset by increases in many other tax rates. In addition to the across-the-board VAT increase, a 9% VAT was imposed on e.g. newspapers and magazines after 2012. Since 2005, tax increases have altogether accounted for some 2% of the increase in consumer prices of industrial goods.

Rents drive up services prices

The high rate of services inflation reflects in particular the rapid increase in rents. In 2007–2015, rents have risen in Finland an average 3.2% per annum, and currently account for around 30% of services. Elsewhere in the euro area rents have risen only 1.6%. As well as rents, other housing costs, including house prices, have risen faster in Finland than in the rest of the euro area. The rents of business premises also climbed swiftly, especially in the early years of the recession.

In addition to housing costs, the prices of e.g. restaurant services and other services have surged. The price increase on these services reflects the stronger wage developments in Finland compared to other euro area countries.

Services account for a significant part of intermediate consumption by the corporate and public sectors. An analysis of the relevance of various services for the increase in service producer prices (Chart 8) shows that professional, technical, scientific and logistic services make a significant contribution to the increase in producer prices. The prices of management consultant services, in particular, appear to have risen rapidly. The price of logistics services has mirrored oil price fluctuations, the effect of which has already turned negative. The contribution of professional and other similar services to the rise in producer prices fell substantially in the years of recession. In the wake of the recession, the prices of the real estate business and of administrative and support services have, in contrast, gained in significance as a driver of the rise in service producer prices.

Services price developments in Finland are discussed in detail in the article Rise in services prices has made Finland an expensive country, published in June 2015.

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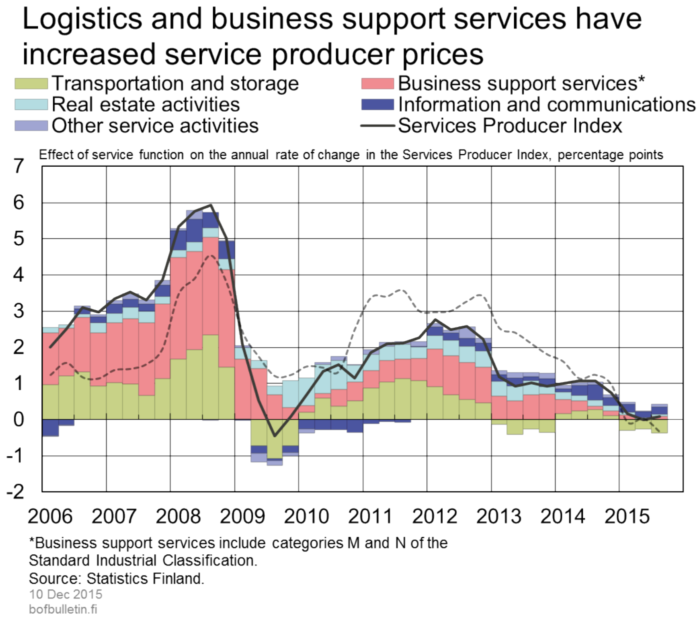

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Tags

euro area, consumer prices