Price Stability

Englischer Filmtext

The film uses typical scenes to explain price stability, inflation and deflation.

Landscape architect:
"And please don't forget to prepare the yew trees for the hedge. Twenty metres long, two metres tall."

Vincent:
"Okay, but that'll be expensive. € 2,000, for sure."

Landscape architect:
"Money isn't an issue with this job. And could you give me a hand for four days greening that roof? I'll pay you well."

Vincent:
"Sure, great, I'd love to."

Landscape architect:
"Great. Bye."

Vincent is 17 and is an apprentice landscape gardener. His current passions are a scooter, which he is saving up to buy ... and his girlfriend, Marie. She is also 17 and wants to become a graphic artist.

Marie:
"And? What do you think?"

Vincent:
"Nice!"

Marie:
"And much cheaper than the scooter you want to buy."

Vincent:
"I'm going to save up my money for my scooter."

Vincent wants to change some Egyptian money back into euros.

Money-changer:
"So, how was your holiday?"

Vincent:
"Great – the sea, the pyramids."

Marie:
"They're five thousand years old. Unbelievable!"

Money-changer:
"So, it would be 5.39."

Vincent:
"Only two years ago the exchange rate was quite different."

Money-changer:
"Well, you shouldn't carry your money with you around at 10% inflation."

Marie:
"What? Within ten years all the money will be gone!?"

Money-changer:
"Not quite, but it wouldn't be worth much more."

PRICE STABILITY

FROM BARTERING TO CASHLESS PAYMENTS

Imagine for a moment that money doesn't exist. You would have to produce almost everything yourself. Chop down trees for firewood, keep chickens, shear sheep and then spin and weave the wool to make clothes. Complicated things like motor scooters and mobile phones would be no more than a pipe dream.

Marie needs a new pair of boots. She can't make them herself. But she can barter: she offers five cabbages, but the shoemaker wants cheese. So first of all Marie exchanges her cabbages for flour, and then the flour for firewood, and the firewood for cheese. Barter chains like these are cumbersome and take time. At least Marie can use the cheese to pay the shoemaker. It could be summer by the time she gets her winter boots.

The barter chain would be shorter, if they could all agree on a joint medium of exchange – for example, eggs. One pair of boots = 500 eggs. Then eggs would be money. People did use commodity currencies in the past. In Ethiopia, for example, blocks of salt used to serve as currency. You could use the blocks of salt not only to buy coffee, but also to pay your taxes. The disadvantage was that salt is soluble in water. Sea snails or pearls, on the other hand, are durable barter media, and so are metals.

For a long time, rare precious metals like silver and gold were ideal barter media. You can't eat gold, but it is indestructible. And you can store it. And precious metals can also be divided up. You can weigh them and therefore calculate their value. And if you use them to make coins, they make even better exchange media or accounting units. You can just count them out.

From early times, princes and states reserved for themselves the right to mint coins. However: carrying large amounts of coins around is not only awkward – it can also be dangerous: The risk of being attacked is high. That is one reason why, during the Middle Ages, banks were established in the main trading centres. The merchants could keep their coins there. Increasingly, people paid with the deposit notes which served as receipts for the coins. And these deposit notes developed into banknotes.

50 years ago, almost everything was still paid for in cash. Workers received their wages once a week in a pay packet. But then companies went over to cashless payments. Since then, almost everybody in Germany has a current account at a bank. People often don't even use cash when shopping; they use a card with which they can access the funds in their bank account. Cashless payments are quick, safe and practical.

Payments become complicated when different currencies are involved. The prices have to be converted or the currencies exchanged. That is one reason why many European countries introduced the euro as the common currency in 1999.

The Eurosystem is responsible for the euro. It consists of the European Central Bank, ECB, and the national central banks of the countries of the euro area. In Germany it is the Deutsche Bundesbank. The presidents of the national central banks and the members of the Executive Board form the Governing Council of the ECB. It is the top decision-making body and determines monetary policy.

Vincent:
"Hello! I'd like to put € 100 into my savings account, please."

Bank employee:
"€ 2,200 on your account. Interest will be accredited at the end of the year. It's not much, interest rates are low at the moment. It's a bad time to be a saver."

Vincent:
"Well, I'm saving for a scooter, I still need € 1,200."

Bank employee:
"You could take out an instalment loan. The current interest rate is 8%, that will cost you less than € 5 a month."

Vincent:
"Sure, if it's possible, great."

Bank employee:
"Just give me a call and we will make an appointment."

When a customer pays cash into the bank, it is entered as credit on his account. The money is then book money. You cannot hold book money in your hands; it can only be seen as a figure on your bank statement.

When a bank grants a customer a loan, it creates new book money. It enters the amount of the loan as a credit balance on Vincent's account. He can withdraw it as cash and use it to pay for the scooter, or he can transfer the money in the form of book money onto the retailer's account.

Vincent has to pay a fee for the money he has borrowed – the interest. And of course he has to pay back the loan.

Today there is far more book money than cash.

There are strict rules regarding the ways banks can lend money and create more book money. The European Banking Authority is responsible for the supervision, and in Germany so are the Deutsche Bundesbank and the Federal Financial Supervisory Authority (BaFin).

The Central Bank is the bank of the banks. It supplies the banks with cash and supports cashless payment transactions. Banks can take out loans from the Central Bank. Then they have to pay interest, just like Vincent. And of course the banks also have to pay back their loans.

The interest rate is determined by the Governing Council of the ECB. This means it determines the price of money: Low interest, cheap money – high interest, expensive money. The price of money, that is the interest rate of the Central Bank, affects all the other prices. That is why it is called the policy rate or base rate.

PRICES, PRICING, PRICE LEVELS

Vendor:
"Hello!"

Marie:
"Hello! I want to make a big fruit salad."

Vendor:
"I've got apples, bananas and some lovely oranges here."

Marie:
"Hm, but they're expensive."

Vendor:
„A frost destroyed half the harvest."

Marie:
"Then I will just take the apples and just two oranges."

The decisions of many individual customers and salesmen determine the price of goods.

Vendor:
"If you come again tonight, I'll give you a good price."

Marie:
"Bye."

Vendor:
"Bye, thank you."

Prices rise and fall according to supply and demand. The price of goods is an important signal. It affects the behaviour of people, who do not know each other and who cannot reach an agreement with each other.

If the demand for a product is greater than the supply, the producers can increase the price. If the price rises too much, the demand will sink because consumers select other products instead. Then the producers are not able to sell their goods. They have to lower the prices so that consumers will buy them again.

The prices of goods and services are constantly being adjusted. They change in order to balance supply and demand.

Vincent:
"How do I look?"

Marie:
"*Like you always do?"*

Vincent:
"I spent € 10 more this time!"

Marie:
"I can take a photo and send it to Anna quickly."

Vincent:
"€ 10, no difference, that's unbelievable."

Marie:
"Look, my new mobile phone. Takes amazing pictures. Look."

Vincent:
"Cool, but I bet it must have cost a fortune."

Marie:
"No, only half the price of my old one."

What Marie and Vincent find expensive or cheap is highly subjective. The Federal Statistical Office establishes an objective price level and measures how it changes. First of all, the statisticians determine how much households spend for the goods and services, they need in their everyday lives. Nowadays, people spend an average of 30% of their income on where they live, 13% on a car and transport, 11% on leisure, entertainment and culture and only 10% on food.

Next, the statisticians determine which products and services are purchased most frequently. That is how they create a "shopping basket". The shopping basket is updated regularly: whatever is out of date is removed. New services like pizza services or products like smartphones are added. 600 employees of the Federal Statistical Office fan out every month and check on 300,000 individual prices – for the same products in the same stores and online shops. They also take special offers into account.

The shopping basket and the prices are used to determine the “consumer price index”. It is used as the yardstick for price levels. The consumer price indexes of all countries which use the euro as currency are combined to produce the harmonised consumer price index for the euro area. It is the yardstick for measuring price levels within the euro area.

The change in the price level is called the inflation rate. When you read in the newspaper that the inflation rate is 0.8%, it means that the price level in this month is 0.8% higher than in the same month one year ago. Price stability means that despite the rise and fall of individual prices, the price level does not change very much. The ECB Governing Council has defined this more precisely. We have price stability when the increase in the price level lies close to, but below 2% in the medium term. If the price level sinks noticeably and over a long period, we speak of deflation. And if the price level rises by much more than 2% over a longish period, we are suffering from inflation.

IF WE HAD INFLATION …

Vincent:
"What? € 3,600?!"

Marie:
"I can guarantee you it will cost even more next year. Buy it now."

Vincent:
"What makes you think that?"

Marie:
"Because everything is getting more expensive lately."

In a year’s time Vincent wants to buy a scooter which costs € 3,600 today. He has already saved € 2,200. Every month he pays € 100 into his savings account.

If there is an inflation rate of 4%, in a year’s time the scooter would cost € 3,744. Vincent would have to save up for one and a half months longer. With an inflation rate of 8% he would have to save for almost another three months. After a year only € 3,333 purchasing power is left. And after nine years the purchasing power will have halved.

Everyone who earns a fixed income is affected by inflation – wage-earners, pensioners and trainees like Marie and Vincent. Initially they simply have to accept the loss of purchasing power resulting from rising prices. You don’t get a wage or pension increase every month.

When things become more expensive, people save less, because they now need more money to live on. Once inflation starts, people quickly lose faith in the stability of the value of money: Marie buys the oranges in spite of their higher price. She is afraid that the fruit will be even more expensive tomorrow. And the farmer holds back his oranges for as long as he can, because prices may continue to rise and then perhaps he can earn even more. Prices lose their signal function. The principle of supply and demand no longer works. Businessmen are reluctant to invest; they lay off employees and unemployment rises. There is insecurity everywhere.

After World War I, Germany suffered from hyperinflation. The value of money plummeted. In 1914 an egg cost eight pfennigs; in January 1923 it cost 139 marks; and in November the price of an egg was 320 billion marks. The economy collapsed; only the firms printing the money worked round the clock. Many people went hungry.

How does inflation happen? What causes inflation?

Marie:
"What, the price of petrol has gone up again?!"

Vincent:
"Well, that doesn't surprise me. With war in the Middle East, no wonder that the price of oil is on the rise."

Marie:
"If it carries on like that, I'll be taking the bus in future."

Vincent:
"Bus fares are going up, too."

Inflation can be triggered by various factors: Wars, economic boycotts or other political decisions. Goods can also suddenly become scarce as a result of natural disasters.

In a long, cold winter there is an increased demand for heating oil. And increased demand means higher prices. Oil is the most important fossil fuel. We use it for heating and cars run on it. And oil is used to make many things: yoghurt pots and garden chairs, paints and clothes. If oil suddenly becomes much more expensive, many services and products will become more expensive too. The price level will rise. This is a so-called "first-round effect". It is very important how companies, the state and consumers react to a price rise like this.

One possible reaction is to save oil where possible and spend less money on goods and services. If this results in weaker overall demand, the general increase in prices will be limited and a real inflationary process will not take place.

Another reaction is to continue to use just as much oil and as many oil products as before. In order to be able to afford the higher prices, people borrow additional money. And companies also borrow more money in order to finance the higher costs. They add these costs to the prices. And workers try to negotiate higher wages in order to finance the higher prices. That can also lead to increased prices. The state also borrows money to finance the increased costs. Increasing amounts of money go into circulation. The increase in the oil price triggers more and more price increases in all sectors of the economy. These are the so-called "second-round effects". An inflationary spiral begins to turn, and if the process is not stopped, it gets faster and faster.

Marie:
"So, she said you could borrow the money?"

Vincent:
"Yeah. 8% interest – that's less than € 5 interest each month."

Marie:
"Hm, it's worth it, as prices are rising daily."

Vincent:
"17% interest, that's daylight robbery!"

Marie:
"She said the Central Bank has raised the base rate. Why would they do that?"

Vincent:
"I won't be taking out a loan with an interest rate that high!"

Why should Vincent suddenly have to pay such a high interest rate for his loan? And why has the policy rate risen?

A stable euro – that is the task of the ECB General Council. The policy rate is the most important instrument to secure price stability. That is the interest rate that the banks pay to the Central Bank when they borrow money from it. If the ECB General Council raises the policy rate, then money becomes more expensive, initially for the banks. The banks pass on the higher interest costs – to their customers. It costs more money to borrow money – for the state, for companies and for Vincent and Marie. The consequence: the demand for loans decreases. Which means that there is less money in circulation than before. So there is a reduction in demand for goods and services. Producers get to feel this: they can no longer raise their prices. Some even sell things more cheaply, so as not to be left with their goods. Prices in general rise more slowly. And over a period of time price stability returns. However: if interest rates on loans are too high, and therefore money is expensive, there is a risk of a recession.

If the economy shrinks, jobs will be lost ... That is why it is so important that there is price stability. Stable monetary value creates the best preconditions for reliable planning and investment. Prices that fall too steeply can be just as dangerous as steeply rising prices.

IF WE HAD DEFLATION …

Vincent:
"Hey, my scooter is cheaper again!"

Marie:
"Buy it now, then."

Vincent:
"Let's see, with the roof greening job done, I'll have the money already. But I think if I wait a little longer, it will be cheaper again."

Marie:
"No, I don't think so."

Vincent:
"Sure it will! It's been reduced twice already …"

If prices fall over a longer period of time, there is deflation. At first consumers are pleased: lots of things become cheaper and they can buy more for their monthly wages. Savers are satisfied too, because the money in their account is worth more. But overall the economy suffers increasingly. And this is why:

Although Vincent and Marie could afford to buy more with their money, they decide not to spend it. They wait for prices to fall even further. And other consumers also postpone buying things; they buy fewer cars and fewer washing machines and less furniture. Businessmen are left with their goods. Because their income is too low they are no longer able to cover their costs. So they reduce production and lay off workers. As a result, demand falls still further …

Landscape architect:

"Sorry Vincent, I have to cancel everything and I won't be needing your help anymore."

Vincent:
"Why?"

Landscape architect:
"The roof greening and yew hedge jobs – both were cancelled. Major cost cuts."

Vincent:
"Oh, that's a pity. I really would have been happy to help you, and I could do with the money …"

Landscape architect:
„Sorry."

Like inflation, deflation can have various different causes. It is often triggered by an extreme situation: an economic crisis or a deep-seated financial crisis. In times like that people don't spend as much. They save more for later. Demand sinks. The businessmen continue to reduce their prices so that they can at least sell something. Deflation can last for a long time.

That is what happened during the 1930s. After a sudden fall in prices on the New York Stock Exchange there was a worldwide slump as demand fell too. Banks collapsed. Industrial production fell by almost half, and many companies went bankrupt. In 1932 the unemployment rate in Germany was over 30%. Two-thirds of public expenditure went on unemployment benefits and welfare payments.

And what can we do to prevent deflation?

Bank employee:
"The good news is – the current interest rate is only 6% for instalment loans."

Marie:
"Is that low?"

Bank employee:
"Well, it would work out at less than € 30 a year."

Vincent:
"Okay, that's the same as the cost of renting a scooter for just one weekend."

Marie:
"Why is it so low?"

Bank employee:
"The base rate has never been lower."

Vincent:
"I think, I'll take out the loan then."

Bank employee:
"May I see your parental consent form, please?"

Vincent:
"Sure."

Even if there is a threat of deflation, the Central Bank must act. The ECB General Council then lowers the policy rate. That means: banks pay lower interest rates for loans which they receive from the Central Bank. And the banks pass the lower interest rates on to the customers. For Vincent, too, money will become cheaper. As a consequence: consumers, companies and also the state start borrowing more money again. As a result more money goes into circulation, the economy can grow and unemployment falls. People buy more things again, and go to the hairdresser's more often. The increasing demand gives companies leeway so that they need not lower their prices any further. Gradually, price stability sets in.

Here, too, the rule is: the effectiveness of lowering the policy rate depends on numerous factors. The Central Bank's opportunities for action are more limited in cases of deflation than they are for inflation because the Central Bank cannot lower the policy rate as much as it likes. Below zero there would be negative interest rates for a credit balance.

Everybody who was faced with negative interest rates would withdraw his or her money from the bank and keep it under the mattress. In such a situation the Central Bank must resort to special measures in order to lower interest rates, for example purchasing bonds. Because deflation is damaging to the economy and is hard to overcome, it should not be allowed to occur. This is why the Eurosystem defines a medium-term increase in price levels of just under 2% as “price stability” – in order to have a buffer against deflation.

Together with the ECB and the other national Central Banks, the Deutsche Bundesbank is responsible for the common currency, the euro. Since the beginning of the currency union, on the whole the Eurosystem has been quite successful at maintaining the goal of “price stability”.

Marie:
"Wow!"

Vincent:
"I paid cash."

Marie:
"Why?"

Vincent:
"I just wanted to use the opportunity to hold once a few fivehundred notes in my hand."

Marie:
"How romantic!"

Vincent:
"You can’t beat the feeling. Pizza at the Italian place? I’ll invite you."

Marie:
"No, Paella at the Spanish place! And it’s on me!"