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PRICE CONVERGENCE IN THE EUROPEAN UNION: WITHIN FIRMS OR COMPOSITION OF FIRMS?

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NON-TECHNICAL SUMMARY

In 1992 the twelve member states of the European Union (EU) completed the Single Market Program (SMP) that had been launched in 1986 to eliminate remaining barriers to economic integration. The approximately 300 measures in the 1985 White Paper aimed at reducing the real cost of trading across borders (e.g. remaining quotas, border checks, different norms and regulations) and the cost of entering specific markets (e.g. remaining capital controls, different legal frameworks). These measures were widely expected to lead to a considerable reduction in market segmentation across EU members. The introduction of a common currency, the Euro, among a subset of EU members in 1999 was supposed to give a further boost to market integration by increasing price transparency, reducing transaction costs and eliminating exchange rate fluctuations. The reduction in market segmentation resulting from the European economic integration process should be reflected in a reduction of the ability of firms to set market specific prices and an increase in the speed of convergence to the law of one price (LOOP).

Our first objective in this paper is to provide a quantitative estimate of the effect of European economic integration on the speed of price convergence. To this end, we use the prices set by French exporters in different export markets at a highly disaggregated product level to test whether there is any difference in the speed of price convergence between EU export markets and an appropriately defined control group (the rest of the OECD).

Our regressions suggest price convergence is 40% faster inside the EU. This can be interpreted in two different ways. First, firms may find it harder to discriminate between markets in the EU, because of stronger arbitrage pressures. This is what we call a within firm or intensive margin effect. A different explanation would attribute the difference in convergence speeds to selection of heterogeneous firms into EU and non-EU markets. Because fixed entry costs are lower in EU markets, less productive firms are able to serve these markets. If productivity is correlated with price decisions, it can be that firms serving EU markets also have less discriminatory pricing strategies. This is what we call a composition or extensive margin effect. The individual dimension of our data allows us to test this second hypothesis. We find that 30% of the convergence gap is due to selection effects. Price discrimination is stronger for larger firms, that are more likely to serve extra-EU markets.

Given that nowadays most of the remaining barriers to market integration are of the entry restricting type (Delgado, 2006, Dierx et al., 2007), in particular in services markets, the quantification of extensive margin effects, which is the main contribution of our paper, seems to us of considerable policy interest.

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