THE WALL STREET JOURNAL.

EUROPE EDITION

Friday, November 17, 2006

# Managing Change: Is the Penny Worth Keeping?

* * *

**Raymond Lombra writes:** Earlier in this exchange, I suggested that in a penny-less world with rounding we could well see strategic pricing behavior by firms to take advantage of rounding schemes. Robert has suggested that competitive pressures will limit or eliminate such strategic behavior, such that the effects would be "trivially small."

A rich and growing literature has addressed the notion of strategic and psychological pricing by firms and rational inattention to the rightmost digits of prices by consumers (see this paper by Daniel Levy and colleagues). As this literature makes clear, one does not need to abandon the competitive model or rationality as central tenets of economic theory and analysis. The implication is that representative consumers in effect "ignore" small price changes, thereby leaving some room for firms to price strategically and opportunistically, whether it be to set prices at a psychologically attractive figure to the consumer, for example, a price ending in a "9," or in a manner to take advantage of any rounding scheme accompanying the elimination of the penny, or both. Of particular relevance to the issues under discussion here, Levy and his colleagues find that the distribution of price changes over eight years for a large retail grocery chain is not random; they are asymmetric, more price increases than decreases, and over 35%

of the price changes were in multiples of 10 cents, thereby preserving the price's last digit.

Such findings suggest European retailers may have acted opportunistically by rounding their prices upward after conversion to the euro in an attempt to preserve psychological prices, and, more generally, to take advantage of consumer inattention. When the dust generated by conversion settled, Eurostat, the European Commission's statistical service, estimated that the impact on the Harmonized Index of Consumer Prices was approximately 0.2%. Interestingly, they found that the price increases were more significant in the services sector and in certain low-price goods bought frequently. For example, price increases in cafes and restaurants were about 4.3% over the first year of conversion, almost double the general inflation rate.

Should such increases be considered "large" or "small"? All the analysis I am aware of suggests the price increases traced to conversion are small relative to the longer-run benefits of a common currency associated with the increased trade, economic growth and development of the European community.

But this brings us back to where we started. Given, the experience with the introduction of the euro, accumulation of other evidence suggesting strategic pricing is not just a theoretical curiosum, and the fact that available evidence suggests eliminating the penny would not be distributionally neutral, I think Robert's conclusions are, to put it gently, premature.



---

Link to the article:

http://online.wsj.com/article/SB116360150549923901.html

and

http://archive.is/V2DVS