

# MENU COSTS AT WORK: RESTAURANT PRICES AND THE INTRODUCTION OF THE EURO\*

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## Abstract

Restaurant prices in the euro area increased dramatically after the introduction of the euro. We argue that this increase can be explained by a common model of menu cost pricing, extended to include the state-dependent decision of firms on when to adopt the new currency. Two mechanisms drive this result. First, firms concentrate otherwise staggered price increases around the changeover. Second, before the adoption of the Euro, prices do not reflect the marginal cost increases expected to occur after the changeover. This “horizon effect” disappears as soon as the new currency is adopted, causing a jump in the optimal price.

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## I. INTRODUCTION

Before euro coins and bills started circulating in January 2002, many feared that the changeover could result in excessive price increases. Ex-post, this alarm appears largely misplaced. According to the European Commission, the increase in the all item Harmonized Index of Consumer Prices attributable to the introduction of the euro was only between 0.12 percent and 0.29 percent. However, prices in particular sectors, most notably restaurants and cafes, increased significantly in the period immediately following the changeover.

In January 2002 alone, prices in the euro area restaurant sector increased by 1.3 percent. In comparison, the all item monthly inflation rate was 0.16 percent. In most countries, restaurant inflation in January 2002 was much higher than its historical average, with peaks of 3.4 percent in the Netherlands and 2.1 percent in Germany. These price increases are not only striking when compared with the historical record. They also contrast sharply with those observed in the EU countries that did not adopt the euro, Denmark (0.1 percent), Sweden (0.2 percent) and the United Kingdom (0.1 percent). This discrepancy between the two groups of countries clearly points to the introduction of the new currency as the most likely cause of the jump in prices.

What could explain such a remarkable effect of a change in currency denomination? One possibility is that the introduction of the euro acted as a coordination device, allowing restaurants to collectively raise their prices, as argued for example by Adriani, Marini and Scaramozzino [2003]. However, this story does not explain why it was the changeover, rather than any other event, that triggered the switch to a high-price equilibrium. Moreover, if the changeover was indeed a suitable focal point for expectations, it is not clear why price increases were not more widespread across sectors. Similar considerations apply to models with boundedly rational agents, like Gaiotti and Lippi [2005] and Mastrobuoni and Dziuda [2005], in which consumers face some friction in translating prices from the old currency to the new. Finally, a third theory emphasizes the role of rounding to attractive prices. However, rounding alone cannot account for the systematic bias towards higher prices observed in the restaurant sector.

We offer an alternative explanation for the unusual behavior of restaurant prices documented above, the existence of menu costs. Central to our analysis is a pricing model for a small sector in the economy, with monopolistic competition and costly price adjustment, modified to take into account the introduction of a new currency.

In this model, as in Dotsey, King and Wolman [1999], price setters face a stochastic cost of changing prices, a menu cost. In addition, they must pay a fixed cost for switching to the new currency. They also incur losses for switching “early” (in our case before January 2002), or “late”. These costs capture the fact that euro cash payments were not possible before January 2002, and that domestic currencies were quickly retired from circulation after the changeover.

Our key assumption is that switching to the euro involves choosing new optimal prices. In particular, we posit that the costs incurred for the adoption of the euro already include the costs normally faced when changing prices. In other words, firms that adopt the euro can also adjust their prices for free.

We study the response of restaurant prices to the announcement of the introduction of the euro in four variants of our pricing model, which correspond to some popular specifications in the literature. In particular, we consider: *i*) Calvo’s [1983] time dependent model, *ii*) a hybrid of Calvo [1983] and Taylor [1980], and *iii*) the state dependent model of Dotsey, King, and Wolman [1999]. In these three cases, we assume for simplicity that all firms must adopt the euro in January 2002. To our surprise, we find that this assumption implies a much larger price jump than observed in the data.

For this reason, we introduce a version of this model with an endogenous adoption margin. In this specification, we calibrate the cost parameters that affect the endogenous adoption decision to match the pace of adoption of the euro among small and medium enterprises (SMEs) in the euro area. For these particular parameter values, the model generates a jump in restaurant prices that is of the same order of magnitude as that in the data.

Two main mechanisms generate this jump. The first concentrates an unusually high fraction of otherwise staggered price changes at the time of the currency switch. This results in a price jump, followed by a protracted period of lower than average inflation, as the distribution of price vintages “churns” back to its steady state. We refer to this as “distributional churning.”

The second mechanism, which we call the “horizon effect”, depends on the fact that cost increases expected to occur after the changeover are not incorporated in the prices that firms set before then. The prices set at the time of the switch, however, do include those costs. As a consequence, in the periods leading up to the changeover, firms have an incentive to postpone price increases, and to increase by less if they do. This results in a decline of inflation, and in a backlog of overdue price adjustments. This backlog is quickly eliminated as firms set prices in the new

currency, thus contributing to the price jump.

This paper shows that the behavior of restaurant prices around the introduction of the euro should not be puzzling. In fact, a menu cost model with a reasonable amount of price stickiness produces at least as much inflation in January 2002 as in the data. In light of this model, the real puzzle is why price increases were not more widespread. Addressing this question is important, because it could provide some insight into the empirical plausibility of sticky price models. We propose three tentative answers.

The first is simply that the kind of price rigidity captured by menu cost models is only relevant for a handful of sectors. This is consistent with the observation that the sectors with significant price jumps around the changeover are among those with the highest measured price stickiness, both in the United States [Bils and Klenow 2004] and in the euro area [Dhyne, Álvarez, Le Bihan, Veronese, Dias, Hoffman, Jonker, Lünemann, Rümmler and Vilmunen 2004].

The second answer is that the switch to euro prices was not generally accompanied by a re-optimization, as we assume here. This would have happened for example if the “thinking” costs of changing prices are significantly higher than the “physical” costs of updating firms’ menus, as found for example by Zbaracki, Ritson, Levy, Dutta and Bergen [2004] in their case-study of a large industrial manufacturer. In this case, firms might not have adjusted their prices when switching to the euro, since adopting a new currency does require to print new menus, but not necessarily to reevaluate the prices in them.

Finally, restaurants that adopted the euro early or late probably faced substantial transaction costs, since payments in the European restaurant sector are predominantly in cash. This might have induced restaurants to concentrate their price increases around January 2002 to a larger extent than in less cash-intensive sectors.<sup>1</sup>

The structure of the paper is as follows. In the next section, we present some evidence on the anomalous price increases in the euro area restaurant sector around January 2002. In section III, we introduce our theoretical framework. This is a partial equilibrium model of a small sector, with monopolistic competition and sticky prices. The partial equilibrium setup is particularly

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<sup>1</sup> The euro became the official currency of the European Monetary Union in January 1999, when the exchange rates of the participating countries were irrevocably fixed. However, euro coins and bills started circulating only on January 1st, 2002. Therefore, pricing in euros was impractical before this date, at least for the purpose of cash payments. Moreover, domestic currencies quickly disappeared from circulation after the changeover. The euro became the sole legal tender in the Union on March 1st, 2002. Therefore, pricing in domestic currency became quite costly almost immediately after January 1st, and simply impossible at the end of February.

appropriate for our purposes, since the introduction of the euro had negligible effects on the general price level, but a big effect on restaurant prices. Section IV describes the main mechanisms that determine the equilibrium inflation rate in the small sector, “distributional churning” and the “horizon effect”. In section V, we show that, for realistically calibrated parameter values, the model with endogenous adoption of the euro generates a spike in inflation that is remarkably close to that observed in the data. Section VI concludes. Mathematical details are relegated to a separate appendix, which is available upon request.

## II. EUROPEAN INFLATION AND THE EURO

In this section we present evidence on the behavior of inflation in the European Union around the changeover to the euro in January 2002. We do so in two steps.

First, we look at overall inflation for the EU12 in the so-called Harmonized Index of Consumer Prices, or HICP.<sup>2</sup> We find that European inflation, as measured by changes in this index, was not unusually high around the changeover. The same is true in each of the twelve Countries that adopted the new currency. Second, we show that the aggregate evidence hides some significant price increases at the sectorial level. These increases are particularly striking for restaurants and cafes, which are the focus of this paper.

### II.A. *The General Price Level*

Figure I shows the evolution of the EU12 HICP inflation rate from January 1994 to March 2004. The data are not seasonally adjusted, since a seasonal filter would smooth out the kind of temporary price changes we are interested in. This explains the series’ high volatility.<sup>3</sup> As is evident from the figure, nothing remarkable happened in or around January 2002. The inflation rate in that month was 0.2 percent. Inflation peaked in March 2002 at 0.6 percent, but very similar peaks recurred in each March since 2001.

Of course, the aggregation of the underlying national inflation rates into the euro area index might very well hide a significant degree of national heterogeneity in the effect of the changeover.

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<sup>2</sup> The EU12 countries are Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. Eurostat’s harmonized CPI for the euro zone is compiled using country weights based on each country’s share of private final domestic consumption expenditures in the zone total.

<sup>3</sup> According to Lünneman and Mathä [2004], the increase in volatility which is evident since January 2001 is due to changes in the treatment of sales.

However, this is not the case. In all countries in the EU12, price movements in or around January 2002 do not stand out against the backdrop of the general volatility and pronounced seasonality of the series. The only possible exceptions are Germany and Spain. In December 2001, the German monthly inflation rate hit 1.1 percent. This is the highest level in the sample. In Spain, inflation climbed to 0.9 percent and 1.4 percent in March and April of 2002 respectively.

On the whole, our reading of this evidence does not support the idea that the changeover to the euro had an unusual impact on European consumer price inflation. Furthermore, the inflation experience in the twelve countries converting to the euro in January 2002 was not very different from that in Denmark, Sweden, and Britain, which opted out of the Monetary Union.

Several studies, like Deutsche Bundesbank [2004] and Del Giovane, Lippi and Sabbatini [2005] for example, have reached similar conclusions. In fact, the European Commissions' official answer to the question: "Has the introduction of euro notes and coins caused prices to rise?" reads

"Analyses by Eurostat, the European Commission's statistical service, indicate that the euro changeover led to some price increases in specific sectors, such as restaurants, cafes and hairdressers, but that the overall effect on prices in the euro area was limited. For the all items Harmonized Index of Consumer Prices, the price increase most likely falls within the range 0.12 percent to 0.29 percent."<sup>4</sup>

However, this answer suggests that the introduction of the euro led to significant price increases in some sectors, like restaurants and cafes, to which we turn our attention next.

## II.B. *Restaurant and Cafe Prices*

Price increases in January 2002 and, in some countries, the subsequent few months, were exceptionally high among restaurants and cafes all across the euro area. Figure II shows the evolution of the monthly inflation rate in the EU12 HICP for this sector from January 1995 through March 2004. The average inflation rate over the period was 0.2 percent. In January 2002, inflation was 1.3 percent. Even in the three months following January 2002, restaurant and cafe prices rose at an average rate more than twice the average. These inflation rates are hardly dramatic in absolute value, and very far from the "rampant price gauging" denounced by some European citizens and

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<sup>4</sup>See [http://europa.eu.int/comm/economy\\_finance/euro/faqs/faqs\\_16\\_en.htm](http://europa.eu.int/comm/economy_finance/euro/faqs/faqs_16_en.htm)

observers [Arnold 2004]. However, they certainly stand out against the historical norm, and represent a challenge to the standard economic prior that changes in currency denomination should have no effect on relative prices.

Moreover, similar price jumps are evident in all the euro area countries. In some of them, the increases were concentrated in January 2002. Finland, France, Germany and the Netherlands, for example, experienced inflation rates between 1.5 percent and 3.5 percent. In other countries, like Italy and Spain, the price increases were more moderate in January 2002, but persisted into the subsequent months.

The behavior of restaurant prices in the three European Union countries that did not adopt the common currency—Britain, Denmark and Sweden—further corroborates the hypothesis that the price increases documented above are connected to the changeover. None of these three countries in fact experienced more than average price increases in the first few months of 2002.

Table I summarizes this striking anomaly. It reports the inflation rate in restaurants and cafes in January 2002, denoted by  $\pi_{Jan2002}$ , the average inflation rate over the period 1995-2003, and its standard deviation. Among the EU12 Countries, with the exception of Greece, inflation in January 2002 exceeded its historical average by between 0.3 percent and 3.1 percent. In the three non-adopting countries, this difference is zero or negative. The column headed  $(\pi_{Jan2002} - \bar{\pi})/s$  scales the difference between inflation in January 2002 and the average by the series' standard deviation. Again, for all EU12 countries, except Greece, inflation in January was between 1.75 and 9 standard deviations away from the mean. This number for the EU12 as a whole is 7.

Of course, part of the anomaly might simply be due to a seasonal effect, since our data is not seasonally adjusted. We control for this by computing the deviation of the average level of inflation in the month of January from the overall mean,  $(\bar{\pi}_{Jan} - \bar{\pi})/s$ . This statistic is reported in the last column of Table I. This calculation shows that inflation in January does tend to be higher than average. However, its magnitude exceeds two standard deviations only in Spain. This confirms that the January 2002 observation is clearly anomalous, even after taking into account January's seasonal characteristics. In the remainder of the paper we will try to make sense of this anomaly in light of commonly used models with sticky prices due to menu costs.

Before proceeding, though, it is important to stress that anomalous price increases following the changeover, although most pronounced among restaurants, were not unique to this sector. For example, several of the national studies of micro consumer prices conducted by the ECB's Inflation

Persistence Network (IPN) find evidence of an increase in the frequency of price changes for some items in or around January 2002.<sup>5</sup> More specifically, Deutsche Bundesbank [2004] documents a significant effect of the euro changeover on the prices of cinema tickets, dry cleaning, hairdressing and restaurants in Germany. Interestingly, these, and other related items, like a glass of beer in a cafe, correspond to seven of the seventeen most sticky prices in Germany [Hoffman and Kurz-Kim 2004], and of the eleven most sticky prices in the euro area. In fact, these seven prices change with a monthly frequency between three and five percent, as compared to an average frequency of fifteen percent for the whole sample. Although not overwhelming, this evidence suggests a connection between price stickiness and the inflationary effect of the euro. We explore this connection in the remainder of the paper.

### III. THE INTRODUCTION OF THE EURO IN STICKY PRICE MODELS

This section describes how we embed the introduction of a new currency in an otherwise standard sticky price model.

Our starting point is a model with stochastic menu costs, along the lines of Dotsey, King and Wolman [1999], DKW in the following. We adopt this framework because it encompasses several sticky price models familiar from the literature, given appropriate assumptions on the distribution of menu costs. In particular, we will consider: *(i)* a Calvo [1983] model, *(ii)* a hybrid of the models of Calvo [1983] and Taylor [1980], also studied by Klenow and Kryvtsov [2005], and *(iii)* the state-dependent model of DKW. In these three models, the timing of the adoption of the new currency is exogenous. In addition, we introduce an augmented version of DKW, model *(iv)*, in which firms decide endogenously when to adopt the new currency.

Our main goal is to compare the ability of these four models to generate a spike in inflation following the changeover. We model this event as follows. Suppose that the economy is on a balanced growth path, with a positive rate of inflation. At time 0, the government announces the introduction of a new currency, the euro, to occur at time  $T > 0$ . For firms, adopting the euro means changing the denomination of their prices. In general, this does not imply a change in the prices' "real" level. However, we assume that the costs of adopting the new currency include the ordinary menu costs. Hence, in equilibrium, firms that switch to the euro will also choose new

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<sup>5</sup> See the overview paper by Dhyne, Álvarez, Le Bihan, Veronese, Dias, Hoffman, Jonker, Lünnemann, Rumler and Vilmunen [2004] and the references therein.

optimal prices. This assumption is crucial for our results. It can be rationalized in one of two ways.

First, by interpreting menu costs narrowly, as the physical costs of replacing the menus. In this case, choosing new prices at the time of the switch can be done at zero marginal cost, since menus must be reprinted anyway. This might be a reasonable first approximation for restaurants.

A second interpretation is to recognize that “translating” a restaurant menu from the old domestic currency to euros might require a “thinking” effort very similar to that of choosing entirely new prices. At least, restaurants had to reevaluate their euro prices to make them “attractive” in the new currency.<sup>6</sup> This suggests that the marginal cost of choosing fully optimal prices, conditional on switching to the euro, was probably low. Our assumption implies that this cost was in fact exactly zero.

Even though we consider a set of models that have been frequently analyzed in the literature, their application here is non standard. The introduction of the euro, and the price reoptimization that this brings about, represent an unusual shock. In particular, this shock causes the distribution of firms over the existing price vintages to collapse into a spike at the new optimal price. This collapse is then followed by a readjustment of the distribution towards its steady state. The nature of the experiment and the implied shift in the distribution are such that we cannot rely on log-linear approximations to solve the model. Therefore, we apply an extended path algorithm that allows us to solve exactly for the equilibrium price index of the restaurant sector, taking as given the evolution of the rest of the economy. Thus, our analysis brings to the forefront some unique non-linear implications of the models, which are lost in the local analysis customary in the literature.

### III.A. *The Model*

Our model describes the partial equilibrium of a small sector in a large economy. Demand for the sector’s goods, as well as factor prices and trend inflation, depend on aggregate conditions. These are taken as exogenous and assumed to be characterized by a balanced growth path, with real growth  $g$  and a positive inflation rate  $\pi$ . Formally,

$$(1) \quad Y_t = (1 + g)^t y, P_t = (1 + \pi)^t p, W_t = [(1 + g)(1 + \pi)]^t w \text{ and } r_t = r,$$

where  $Y_t$  is output,  $P_t$  the aggregate price level,  $W_t$  the nominal wage and  $r_t$  the nominal interest rate.

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<sup>6</sup> See Aucremanne and Cornille [2001] on the incidence of “attractive” prices and their role in the changeover.

The model's small sector, call it  $i$ , is the theoretical counterpart of the restaurant sector in the data. It faces a constant elasticity demand function of the form

$$(2) \quad Y_{it} = \left( \frac{P_{it}}{P_t} \right)^{-\eta} Y_t,$$

where  $P_{it}$  is an appropriately defined price index, discussed in more detail below. The sector is populated by a continuum of firms. They supply a differentiated product, indexed by  $k \in [0, 1]$ , with demand

$$(3) \quad Y_{ikt} = \left( \frac{P_{ikt}}{P_{it}} \right)^{-\varepsilon} Y_{it} = \left( \frac{P_{ikt}}{P_{it}} \right)^{-\varepsilon} \left( \frac{P_{it}}{P_t} \right)^{-\eta} Y_t.$$

The parameter  $\varepsilon > 1$  is the elasticity of substitution in the CES preferences that generate these demand functions. As a consequence, the price index for the sector is

$$(4) \quad P_{it} = \left[ \int_0^1 \left( \frac{1}{P_{ikt}} \right)^{\varepsilon-1} dk \right]^{\frac{1}{1-\varepsilon}}.$$

This index is a key object in the analysis. It is the model's equivalent of the EU12 HICP for restaurants and cafes constructed by Eurostat. Our goal is to reproduce in the model the spike in this index observed in January 2002.

As in DKW, firms face a stochastic cost of adjusting their prices, denoted by  $\xi$ . Its realization is drawn independently by each firm in each period, from a distribution with c.d.f.

$$(5) \quad G_t(\xi) = \begin{cases} 0 & \text{for } \xi < 0 \\ \gamma_{1t} + \gamma_{2t} \tan(\gamma_{3t}\xi + \gamma_{4t}) & \text{for } 0 \leq \xi < \bar{\xi}_t \\ 1 & \text{for } \bar{\xi}_t \leq \xi. \end{cases}$$

Note that this distribution has only three free parameters, since two of the five parameters are pinned down by the restrictions  $G_t(0) = 0$  and  $G_t(\bar{\xi}_t) = 1$ .

Both Calvo's time-dependent formulation and the hybrid of Calvo [1983] and Taylor [1980] studied by Klenow and Kryvtsov [2005] can be thought of as limiting cases of this model. In fact, when  $\bar{\xi}_t \rightarrow \infty$ , and the tangent function becomes a step of height  $\alpha$ , the menu cost is zero with probability  $\alpha$ , and infinite with probability  $1 - \alpha$ . This is the Calvo model. When  $\bar{\xi}_t < \infty$  instead, a fraction  $\alpha$  of firms still draws a zero menu cost, and always reoptimizes. In addition, the firms whose benefit from adjusting exceeds the maximum menu cost,  $\bar{\xi}_t$ , also reoptimize. This results in an endogenous upper bound on the distribution of price vintages, as in Taylor's [1980] staggered contracts model.

Firms in sector  $i$  operate a constant returns to scale technology with nominal marginal cost  $\Psi_t$ . This is taken as given by each firm and grows along the balanced growth path according to

$$(6) \quad \Psi_t = (1 + \pi)^t \psi.$$

Following most of the literature, we abstract from the kind of heterogeneity in marginal costs considered by Golosov and Lucas [2003]. They argue that the high volatility of idiosyncratic shocks is likely to offset the inertia in prices due to menu costs. However, the fact that restaurant prices are among the stickiest in both the United States and Europe suggests that, in this sector, marginal cost shocks are small compared to menu costs. Therefore, our results would be robust to the introduction of a degree of heterogeneity in costs compatible with this observation.

Profits net of the menu cost can be written as

$$(7) \quad (P_{ikt} - \Psi_t) Y_{ikt} - W_t f_t$$

where  $f_t$  denotes the flow cost of “currency mismatch” in terms of labor. In particular, firms charging euro-denominated prices before time  $T$  must pay a cost of  $f_t = f^E$  per period, while firms sticking to the old currency after time  $T$  spend an additional  $f_t = f^D$  units of time on transactions. Moreover, we assume that firms must pay a one time “switching” cost, denoted by  $c$ , as well as the menu cost  $\xi$  whenever they first start charging in the new currency.

Our first three models, in which we assume that all firms need to adjust at time  $T$ , correspond to the case  $f^E = f^D = \infty$ . In the model with endogenous adoption instead, these costs are finite and give rise to an endogenous margin for the adoption of the new currency. In this case, since the total adoption cost, inclusive of the menu cost,  $c + \xi$ , is stochastic, firms have an incentive to postpone the switch, in the hope of drawing a low menu cost, or to anticipate it, in the case their current draw is low. In this sense, the endogenous adoption decision is very similar to the regular decision to change prices, except that the cost of inaction also includes the revenue loss  $W_t f_t$ .

Let  $V_{0,t}^D$  denote the value of a firm, gross of the adjustment cost, if it adjusts its price at time  $t$  and decides to denominate its new price in the ‘old’ domestic currency. Similarly, let  $V_{0,t}^E$  be the value of a firm that adjusts its price at time  $t$  and decides to charge its new price in euros. Let  $V_{j,t}^D$  be the value at time  $t$  of a firm that set its domestic currency denominated price  $j$  periods ago and let  $V_{j,t}^E$  be the value of a firm that set its euro-denominated price  $j$  periods ago. Let  $\Pi_{j,t}^D$  denote the flow profits earned at time  $t$  by a firm that adjusted its domestic currency denominated price  $j$  periods ago.  $\Pi_{j,t}^E$  is similarly defined for firms with a euro-denominated price.

The value function of a firm adjusting its price at time  $t$  in terms of the original currency can be written as follows

$$(8) \quad V_{0,t}^D = \max_{P_{D,t}^*} \left\{ \Pi_{0,t}^D + \frac{1}{1+r} E_t \max \{ V_{0,t+1}^D - W_{t+1} \xi_{t+1}, V_{0,t+1}^E - W_{t+1} \xi_{t+1} - W_{t+1} c, V_{1,t+1}^D \} \right\}.$$

That is, a firm that adjusts its price at time  $t$  and sets this adjusted price in terms of the domestic currency, chooses its new price level,  $P_{D,t}^*$ , to maximize the sum of its current flow profits and the discounted continuation value.

This continuation value is the expected maximum net value of three options faced by the firm in the next period. The first option is to adjust its price in the next period and pay the menu cost  $\xi$ . The second is to adjust its price and change to the euro in the next period. The cost of this choice is the sum of the menu cost,  $\xi$ , and the euro adjustment cost,  $c$ . The third option is to continue into the next period with the price already set.

In this setting, the only source of heterogeneity across firms is the realized level of the adjustment cost,  $\xi_{kt}$ . However, this realization does not affect the firm's value ex-ante, since the adjustment costs are independent over time and across firms. This implies that all firms that change their price and continue to denominate it in the domestic currency change it to the same level,  $P_{D,t}^*$ . For this reason, we dropped the firm index  $k$  in the equation above.

A firm that changes its euro-denominated price at time  $t$  has the value

$$(9) \quad V_{0,t}^E = \max_{P_{E,t}^*} \left\{ \Pi_{0,t}^E + \frac{1}{1+r} E_t \max \{ V_{0,t+1}^E - W_{t+1} \xi_{t+1}, V_{1,t+1}^E \} \right\}.$$

It again chooses its new price, in this case  $P_{E,t}^*$ , to maximize the sum of its flow profits plus the discounted value of its expected continuation options.

The continuation value is the expected maximum of only two options. The first is to change the price in period  $t+1$ , thus incurring the menu cost  $\xi$ . The second is to continue at the existing price. This firm faces one less option in the next period than the firm that is still charging its prices in the domestic currency, because we assume that the switch to the euro is irreversible.

Finally, the value of a firm that does not adjust its price and still charges in terms of its domestic currency is

$$(10) \quad V_{j,t}^D = \Pi_{j,t}^D + \frac{1}{1+r} E_t \max \{ V_{0,t+1}^D - W_{t+1} \xi_{t+1}, V_{0,t+1}^E - W_{t+1} \xi_{t+1} - W_{t+1} c, V_{j+1,t+1}^D \},$$

while a firm that set its price in euros  $j$  periods ago has value at time  $t$  equal to

$$(11) \quad V_{j,t}^E = \Pi_{j,t}^E + \frac{1}{1+r} E_t \max \{ V_{0,t+1}^E - W_{t+1} \xi_{t+1}, V_{j+1,t+1}^E \}.$$

As before, the option of charging in the old domestic currency does not appear in the continuation value, because of the irreversibility of the switch to the Euro.

#### IV. EQUILIBRIUM INFLATION DYNAMICS

What happens to the path of inflation in the restaurant sector in response to the announcement of the introduction of the euro? In this section we describe the two basic mechanisms that determine the transitional equilibrium path of inflation, *(i)* distributional churning, and *(ii)* the horizon effect. We limit ourselves to the intuitive illustration of these concepts and of the way in which they influence the evolution of prices in equilibrium. Some of the analytical details can be found in the appendix.

The equilibrium dynamics for sector  $i$  after the announcement of the introduction of the euro are determined by three factors: *(i)* how many firms in each period update their prices, *(ii)* what fraction of firms chooses to change denomination, and *(iii)* how much these firms raise their prices.

These quantities reflect in turn the evolution of two classes of equilibrium objects. The first is the prices set by reoptimizing firms. As argued above, there are only two such prices.  $P_{D,t}^*$ , for all the firms that update their price at time  $t$  and choose the domestic currency, and  $P_{E,t}^*$ , for the firms charging in euros. The second important equilibrium variable is the distribution of firms over the relevant state space. At any point in time, the two factors that distinguish firms and are relevant for their price setting behavior are *(i)* how long ago they changed their price, indexed by  $j$ , and *(ii)* in what denomination that price is charged, indexed by  $S \in \{D, E\}$ . We denote the fraction of firms in period  $t$  that changed their price  $j$  periods ago and that charge it in denomination  $S \in \{D, E\}$  as  $\omega_{j,t}^S$ .

In equilibrium, the set of price vintages is countable. Hence, the equilibrium price level can be written as

$$(12) \quad P_{it} = \left[ \sum_{S \in \{D, E\}} \sum_{j=0}^{\infty} \omega_{j,t}^S \left( \frac{1}{P_{S,t-j}^*} \right)^{\varepsilon-1} \right]^{\frac{1}{1-\varepsilon}}.$$

From this expression we see that, given the evolution of the distribution  $\{\omega_{j,t}^S\}_j$ , the path of restaurant prices is completely characterized by the sequence of optimal prices  $\{P_{S,t}^*\}_t$ .

As in Calvo [1983] and DKW, firms set their price as a markup over a weighted average of current and future levels of marginal costs. More formally,

$$(13) \quad P_{S,t}^* = \frac{\varepsilon}{\varepsilon - 1} \sum_{j=0}^{\infty} \Omega_{j,t}^S \Psi_{t+j} = \frac{\varepsilon}{\varepsilon - 1} \Psi_t \sum_{j=0}^{\infty} \Omega_{j,t}^S (1 + \pi)^j \text{ for } S \in \{D, E\}$$

where  $\varepsilon/(\varepsilon - 1) > 1$  is the gross markup and the weights  $\{\Omega_{j,t}^S\}_j$  sum to one. These weights depend on three things.

The first is the discount factor  $\lambda = (1 + g)(1 + \pi)/(1 + r) < 1$ . The lower the discount factor, the less the firm cares about future profits relative to current profits. This reduces the degree to which the firm takes into account future marginal costs in setting the current price.

Second,  $\Omega_{j,t}^S$  depends on the probability of not having adjusted the price  $j$  periods after time  $t$ . The intuition is as follows. Under flexible prices, the firm always chooses its price to equal the markup times the current level of marginal cost. However, when it is not sure when it will adjust its prices again, the firm not only takes into account current marginal costs, but also the marginal cost levels that it is likely to face before adjusting its price again. The more likely it is to face a particular marginal cost level, the more weight this gets in the price setting policy. When a firm adjusts its price at time  $t$ , the likelihood of facing a marginal cost level of  $\Psi_{t+j}$  before adjusting its price again is determined by the probability of not having adjusted the price again  $j$  periods after time  $t$ .

The final factor affecting the weights is the effect of the sector's price level on the demand for a firm's good. As long as a firm does not adjust its price, this will drop relative to the sector's price level  $P_{it}$ . The effect of the level of  $P_{it}$  on the demand for firm  $k$  is given by the demand function

$$(14) \quad Y_{ikt} = P_{ikt}^{-\varepsilon} P_{it}^{\varepsilon - \eta} P_t^\eta Y_t.$$

Hence, whenever the within sector price elasticity of demand,  $\varepsilon$ , is bigger than the price elasticity of demand for the sector as a whole,  $\eta$ , an increase in  $P_{it}$  increases the marginal revenue of firm  $k$ . In that case, if all other firms charge a higher price, contributing to an increase in  $P_{it}$ , firm  $k$  will want to charge a higher price as well. Because an individual firm's best price setting response is increasing in the prices set by the other firms, this is a strategic complementarity in the sense of Cooper and John [1988].

Two main mechanisms affect the path of  $P_{it}$  in sector  $i$  after the announcement of the introduction of the euro. We discuss them in turn.

**Distributional churning** On the model's balanced growth path, a constant fraction of firms update their price in each period. Klenow and Kryvtsov [2005] find that this is approximately the case for most sectors in the United States

The introduction of the euro, however, causes an anticipated deviation from this pattern, inducing all firms to change their prices within a short time. This results in a shift in the price distribution towards more recent prices. In particular, in models (i) through (iii), all the mass is at  $j = 0$  at time  $T$ , when all the firms adopt the euro and update their price. Because of the endogenous adoption decision, this shift is less pronounced in model (iv).

This churning of the distribution of prices has two effects on the level of inflation. First, it leads to higher inflation in, or around, time  $T$ . This is because in that period a disproportionate number of firms are raising their prices. Second, after the adoption of the euro, the distribution of prices has a relatively small variance. As a consequence, firms adjusting their price in the subsequent periods will not raise it as much as in steady state. This depresses inflation after time  $T$ . This is illustrated in the bottom panel of Figure III, which depicts the price adjustments in the steady state relative to those  $s^*$  periods after  $T$ . At time  $T + s^*$ , the distribution of firms over how long ago they last adjusted prices is (approximately) truncated at  $s^*$ . As a result, average price increases are smaller for firms that change their prices.

**Horizon effect** As we noted above, the weights of future marginal costs in the optimal price set in period  $t$ ,  $\left\{ \Omega_{j,t}^S \right\}_j$ , are decreasing in the probability of adjusting before  $t + j$ . The introduction of the euro implies that firms charging in the domestic currency will certainly change their price on, or around, time  $T$ . Consequently, prices set before the euro do not take into account marginal cost increases expected to occur after its adoption.

This leads to a decline in inflation before time  $T$ , for two reasons. First, firms that adjust need to increase prices by less than in steady state, since they know they will soon be adjusting again. Second, in the state dependent models, some firms choose to postpone their reoptimization for the same reason. Once a firm adopts the euro though, its price adjustment horizon expands again. Therefore, its new price will reflect increases in marginal costs over a much longer horizon than

before.

This effect is illustrated in the top panel of Figure III. The thick line in the top half of the figure represents the path of future increases in marginal costs. Below are two weighting schemes. The first depicts the weights on future marginal costs applied by firms along the balanced growth path. The second is the truncated sequence of weights used by firms in models (i) through (iii) when setting their prices  $s^*$  periods before the introduction of the euro. In model (iv), these weights are not necessarily truncated, but will decline rapidly around  $s^*$ , depending on the equilibrium speed of adoption.

As a result of the horizon effect, the prices set by euro adopters reflect future marginal cost increases that were not incorporated into the prices they previously charged. This implies that these firms increase their prices at a much higher rate than their counterparts still charging in the old currency. Note that this phenomenon occurs only when nominal marginal costs are expected to increase in the future, as is the case when average inflation is positive.

The next section illustrates the contribution of these two mechanisms to the blip in inflation at the time of the introduction of the euro.

## V. HOW DOES THE MODEL COMPARE TO THE DATA?

In this section, we compare the implications of the introduction of the euro in our four models with the evidence on restaurant price inflation in the euro area.

First, we calibrate the models' parameters. Those related to the balanced growth path are based on euro area averages for the period 1995-2003. We choose  $r = 5.9$  percent, the long-term interest rate on government bonds,  $\pi = 2.8$  percent, the inflation rate for restaurants and cafes, and  $g = 2.0$  percent, the growth rate of real GDP.

As for the demand parameters, we choose  $\varepsilon = 11$ , which corresponds to a ten percent markup in the flexible price equilibrium. This is a common choice in the empirical literature on the New Keynesian Phillips curve [Galí, Gertler, and López-Salido 2001]. To pick  $\eta$ , we note that goods are likely to be closer substitutes within rather than across sectors. This would imply  $\eta \leq \varepsilon$ . As a benchmark, we focus on the corner case  $\eta = \varepsilon$ . Our results are relatively insensitive to lower values of  $\eta$ .

Calibrating the parameters of the menu cost distribution is crucial for our results. Unfortunately,

direct evidence on restaurants' menu costs is not available. However, what is important for our application is the stickiness implied by certain cost parameters, rather than their magnitude. For this reason, we calibrate the parameters of the menu cost distribution so that in steady state the model replicates the degree of price stickiness observed for restaurants in the data.

The source of these data is a survey conducted by the Dutch Centraal Planbureau [2002], asking restaurant owners about the average annual number of regular price adjustments in their establishment. 13 percent reported that they adjust their prices on average less than once a year, 69 percent responded that they adjust once a year, while 18 percent reported adjusting their prices on average two to four times a year.<sup>7</sup> The main advantage of this survey is that it contains enough information to calibrate the three parameters of our model's cost distribution. Moreover, it is unique in its focus on the restaurant sector. Its main disadvantage is that it covers only one country. However, a comparison of the Dutch survey results for the overall economy, with those reported by Fabiani, Druant, Hernando, Kwapil, Landau, Loupias, Martins, Mathä, Sabbatini, Stahl and Stokman [2004] for the euro area, suggests that the amount of price stickiness in the Netherlands is fairly representative of European pricing practices.

Note that the regular price adjustments for restaurants reported in the survey appear more frequent than the changes in the prices of individual restaurant items in the United States [Bils and Klenow 2004] and the EU [Dhyne, Álvarez, Le Bihan, Veronese, Dias, Hoffman, Jonker, Lünnemann, Rumler and Vilmunen 2004]. This difference might be explained by the fact that printing a new menu, our interpretation of the "regular price adjustment" measured by the Planbureau, does not necessarily imply changing all the prices on the menu [MacDonald and Aaronson 2000]. In any case, the relative price flexibility implied by our calibration would bias the results towards finding little effect of the changeover on prices. As we will see in the rest of this section however, the main shortcoming of the first three models we consider is in fact the opposite. We would need even more price flexibility to fit the observed price jump.

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<sup>7</sup> In practice, our model implies that there is always a strictly positive fraction of firms that adjust their prices between 5 and 12 times a year. The calibration uses the approximation that 17 percent of firms adjust their prices two to four times a year and that the remaining 1 percent adjusts more than four times.

## V.A. The *Calvo Model*

The first specification we consider is based on Calvo [1983], in which only a fraction  $\alpha$  of restaurants can adjust its prices every period. We calibrate this parameter to match the 13 percent of Dutch restaurants that reset their prices less than once per year.

Figure IV depicts the monthly restaurant inflation rate in the euro area, along with the path implied by the Calvo model, for the four years from January 2000 through December 2003. The equilibrium path of inflation in the model shows a slight decline before January 2002. This is the result of the horizon effect. After January 2002, the model predicts an even bigger decline, due to distributional churning, followed by a return to steady state.

What is most striking about this picture, however, is the magnitude of the price jump predicted by the model in January 2002. This corresponds to a monthly inflation rate of 4 percent, compared to the 1.3 percent in the data. To be able to replicate the observed rate of inflation, we would need to assume that only 1.5 percent of restaurants adjust their prices less than once a year. Translated on a monthly frequency, this implies an average price duration of 3 months. This compares with an average duration of price spells of 13 to 15 months in the euro area [Dhyne, Álvarez, Le Bihan, Veronese, Dias, Hoffman, Jonker, Lünnemann, Rumler and Vilmunen, 2004] and of 7 months in the United States [Bilas and Klenow 2004]. Clearly, the Calvo model would need unrealistically high levels of price flexibility to match the magnitude of the January 2002 inflation flare.

The main explanation for this surprising result is the assumption that, at any point in time, a positive fraction of firms have not adjusted their prices for an arbitrarily long period. This implies that, when the euro is introduced in January 2002, some pizzas are still being sold at prices set in 1902! But the pizzerias that have not been able to set their prices for a century will change them at time  $T$ , along with everybody else, and increase them by a very high percentage. The smaller  $\alpha$ , the higher the fraction of this type of restaurants, and the more pronounced the inflation spike.

In traditional analyses of the Calvo model, this assumption is not very important. This is because they rely on a log-linear approximation around a steady state with no inflation, in which the distribution of firms over price vintages is degenerate. In our experiment, on the contrary, the introduction of the euro represents an exogenous shock to the timing of price setting, which results in a reshuffling of the distribution of firms. In the ergodic state, only a fraction  $\alpha$  of the pizzerias with 1902 prices resets them each period. Moreover, with zero average inflation, old prices need

not be very far from the current optimal one. In our experiment instead, all the pizzerias update at time  $T$ . In addition, a positive average inflation makes 1902 prices a very small fraction of their current desired level, causing a very large jump at the time of adjustment. These two facts together are behind the inflation spike produced by the model.

### V.B. *Calvo-Taylor Hybrid and DKW Model*

The presence of century-old prices in the Calvo model is clearly counterfactual. However, we can easily eliminate this undesirable feature of the model by considering a finite maximum menu cost,  $\bar{\xi}$ . This leads firms not to change their prices for only a finite number of periods. The result is a hybrid of the Calvo and Taylor models, our model *(ii)*.

Simulating this model requires the choice of two parameters: the probability of facing no menu costs,  $\alpha$ , and the size of the maximum menu cost, denoted by  $\bar{\xi}$ . In line with the Dutch evidence from Centraal Planbureau [2002], we calibrate them so that, along the balanced growth path, 13 percent of restaurants change their prices less than once a year and 86 percent do so between once and four times a year. This implies that the average menu cost incurred by firms resetting their price is only 0.03 percent of their monthly revenue.<sup>8</sup>

Figure V depicts the equilibrium path of inflation in the Calvo-Taylor hybrid model. As expected, truncating the distribution of firms over price vintages reduces the inflation blip in January 2002 by about half. Inflation drops from 4 percent in the Calvo model to 2.5 percent in the Calvo-Taylor hybrid. However, this is still two times as high as in the data.

An interesting feature of this model is that it produces inflationary “echoes” following the switch to the euro. For our calibration, these echoes have a fairly long period of 23 months and are not very pronounced. In Figure V, they are recognizable in the 0.4 percent price increase in November 2003. The problem with these echoes is that they would become more pronounced, if we reduced the upper bound on the menu costs,  $\bar{\xi}$ . But this is what is needed to reduce the inflation blip implied by the model. Either way, the model has clearly counterfactual implications.

There are several ways of eliminating the echoes implied by the hybrid model. One possibility is to introduce some noise, by adding a dimension to the state space. This is the approach followed by Golosov and Lucas [2003] for example, who assume that firms face idiosyncratic marginal cost

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<sup>8</sup> The average cost incurred is very low because most of the adjusting firms in this model do not pay any menu cost. The maximum menu cost is 5 percent of revenue. The oldest price in the distribution is 21 months old.

shocks. Here, we follow a simpler route, since the heterogeneity of marginal costs is not central to our analysis. In particular, we spread the probability mass of the menu cost distribution over the interval  $(0, \bar{\xi})$ , according to the c.d.f. (5).

Simulation of this model requires calibrating three parameters. We pick them by matching the three observations about price adjustment frequencies in the Dutch restaurant sector reported in section V. The calibrated parameter values imply an average menu cost equal to 0.46 percent of monthly sales and a maximum price duration of 25 months. These values are well within the range found in the literature.

The results for this specification are depicted in Figure V. As anticipated, adding probability mass to  $(0, \bar{\xi})$  smooths out the echo effects. However, it does not significantly contribute to reducing the inflation spike implied by the model. The next step is then to allow firms to choose when to make the transition to the euro. This is taken up in the next section.

### *V.C. Endogenous Adoption of the Euro*

In the simulations above, we always assumed that all firms adopted the euro in January 2002. However, a series of surveys conducted by Gallup Europe on behalf of the European Commission, before and after the changeover, suggests that this was not the case in practice. For example, the survey conducted in October 2001 found that 29 percent of small and medium enterprises (SMEs), i.e. those with less than 250 employees, already invoiced in euros, or planned to do so before January 2002, while 62 percent claimed they would switch to the new currency in January 2002. The rest was planning to make the transition after January. The numbers are almost identical for firms with less than nine employees.

If we take this evidence as representative of what happened in the restaurant sector, which in Europe is dominated by small enterprises, the simulations above clearly exaggerate the impact of the changeover on the incidence of price reoptimizations in January 2002. A more realistic model of the adoption process might therefore help reconciling theory and data. This extension results in an augmented version of DKW, our model (*iv*).

To implement this model, we must calibrate three additional parameters. They are the flow costs of anticipating or delaying the adoption before or after January 2002,  $f^E$  and  $f^D$ , and  $c$ , the fixed cost incurred when actually adopting the new currency. This is just a fixed “surcharge” on

the usual menu cost, representing one time expenses like updating the cash register. It is calibrated to 7.5 percent of average monthly revenue, the cost of euro adoption for Dutch restaurants reported by the Centraal Planbureau [2002].<sup>9</sup> As for the costs of currency mismatch,  $f^E$  and  $f^D$ , they are chosen to replicate the pace of euro adoption for SMEs reported by Gallup Europe [2001]. Note, however, that the absolute level of these costs is inconsequential for our results. What matters instead is the marginal cost of the switch,  $c + \xi$ , relative to the cost of not switching, which includes the currency “mismatch” and the lost profit from a suboptimal relative price.

The resulting equilibrium path of restaurant price inflation is plotted in Figure VI. At 1.6 percent, the simulated inflation blip is remarkably close to the 1.3 percent observed in the data. Due to the calibrated 29 percent of firms adopting in December 2001, the inflation rate in that month is also somewhat higher than the 0.26 percent in the data. On the other hand, distributional churning depresses the inflation rate in the first few months of 2002. In the data, on the contrary, inflation remains above average for several months. This suggests that the euro adoption process might have been slower in the restaurant sector than in the sample of SMEs.

Shifting more firms towards a late adoption would also contribute to a further reduction in the inflation spike predicted for January, bringing the model even more in line with the data. However, the scope for such a shift is limited, since national currencies ceased to be legal tender in the Union at the end of February 2002. This suggests that the adoption process must have been completed by then. The model closely replicates this observation. In fact, it implies an adoption rate for February of 98.5 percent.

In conclusion, we find that a menu cost model with endogenous adoption closely replicates the response of restaurant prices to the introduction of the euro, especially with regard to the inflation flare of January 2002. The state-dependent choices of both the timing of price changes and the adoption of the new currency are an integral part of the model’s ability to replicate the facts. The former insures that prices are never too far from their optimal level, thus limiting the amount of latent inflation stirred up by the changeover. The latter spreads this inflation over several periods, rather than concentrating it entirely in January 2002.

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<sup>9</sup> This number is computed by the Planbureau on the basis of a survey conducted by the Dutch National Bank, which estimated adoption costs for the Dutch restaurant sector of about 95 million euros, on annual revenues of 15 billion.

## VI. CONCLUSION

The increase in restaurant prices in the euro area that coincided with the introduction of the euro in January 2002 was unprecedented. Countries like the Netherlands and Germany witnessed monthly price increases of the same magnitude as those usually experienced in a year.

In this paper, we showed that these price increases, although extraordinary, should have not been unexpected. In a reasonably calibrated model with sticky prices and an endogenous decision to adopt the euro, a spike in inflation is the natural consequence of the repricing induced by the switch to the new currency. The key assumption in this respect is that posting menus in euros for the first time leads restaurants to also choose new prices. This has two effects on inflation.

First, a higher fraction of firms updates their prices in, or around, the changeover, thus raising inflation. We refer to this effect as “distributional churning,” since it represents a shock to the distribution of price vintages. Second, these firms also raise their prices at a higher rate than in the absence of the new currency. This is the “horizon effect.” Since firms know that they will have the opportunity to adjust their prices when they switch to the euro, the prices they set before that time do not reflect the increases in marginal costs expected to occur after the adoption. This actually depresses inflation in the period leading to the changeover. As soon as firms adopt, however, their new price reflects the future cost increases, contributing to the jump in inflation.

In this paper, we studied data from only one European sector, restaurants and cafes, in which the inflationary effect of the euro was particularly pronounced. We think that this sector’s response to the changeover was unusual for three main reasons. First, its prices are very sticky. Second, the costs normally incurred to update its prices were already part of the euro adoption costs. Third, restaurants concentrated their transition to the euro around January 2002, because of the cash-intensive nature of their business.

We also focused on one particular quantitative prediction of the model, that of a spike in inflation in January 2002. But the model has several more testable implications. For example, it establishes a tight relationship between the average duration of prices and the magnitude of the inflation blip. Moreover, it predicts a decline in inflation before and after the blip, but no long run effects on relative prices. Testing these implications across countries and goods is a promising avenue for future research.

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TABLE I:

Restaurant and cafe inflation in the EU15 in January 2002

Country	$\pi_{Jan2002}$	mean ( $\bar{\pi}$ )	std.dev.( $s$ )	$(\pi_{Jan2002} - \bar{\pi})/s$	$(\bar{\pi}_{Jan} - \bar{\pi})/s$
Austria	0.5	0.2	0.2	2.0	0.8
Belgium	0.5	0.2	0.2	1.7	-0.1
Finland	2.0	0.2	0.3	5.6	1.0
France	1.4	0.2	0.2	8.1	1.5
Germany	2.1	0.1	0.2	9.0	0.8
Greece	0.3	0.5	2.1	-0.1	0.1
Ireland	1.2	0.4	0.4	2.0	0.5
Italy	0.8	0.3	0.2	3.3	0.4
Luxemburg	1.3	0.2	0.2	4.7	1.1
Netherlands	3.4	0.3	0.4	7.4	1.8
Portugal	1.4	0.3	0.4	2.8	1.0
Spain	1.2	0.3	0.2	3.7	2.4
EU12	1.3	0.2	0.2	6.9	1.7
Denmark	0.1	0.2	0.2	-0.4	0.3
Sweden	0.2	0.2	0.3	0.0	-0.2
Britain	0.1	0.3	0.1	-1.3	-0.6

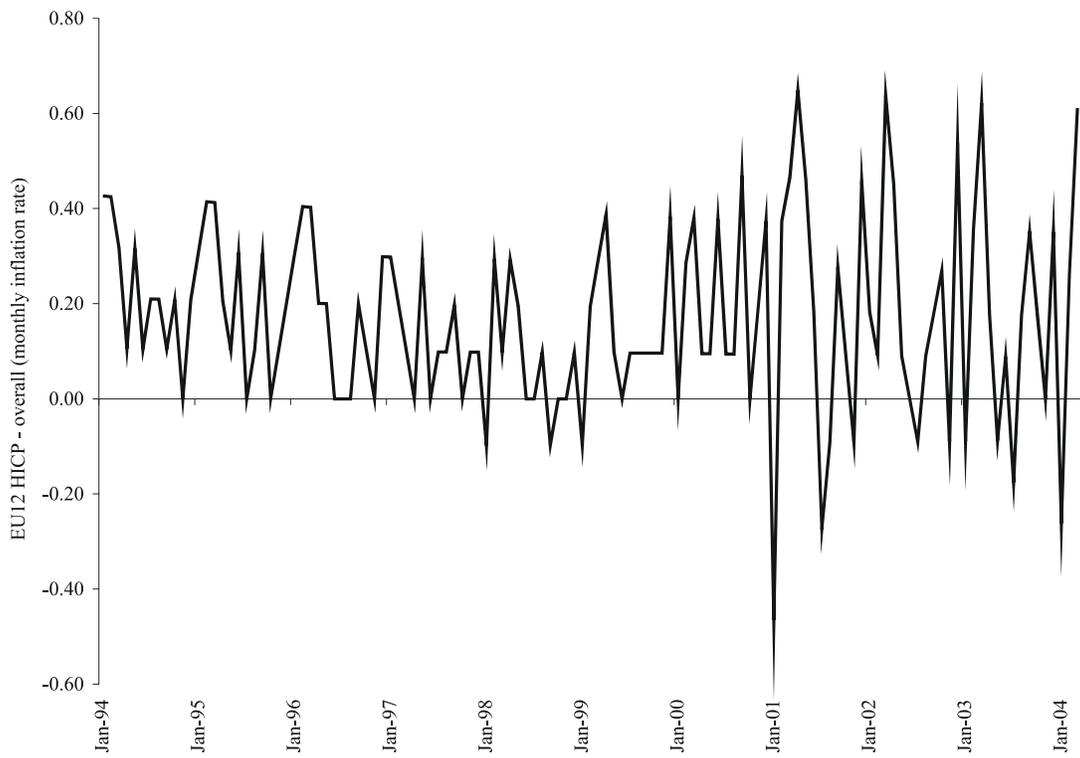


Figure I: EU12 overall inflation

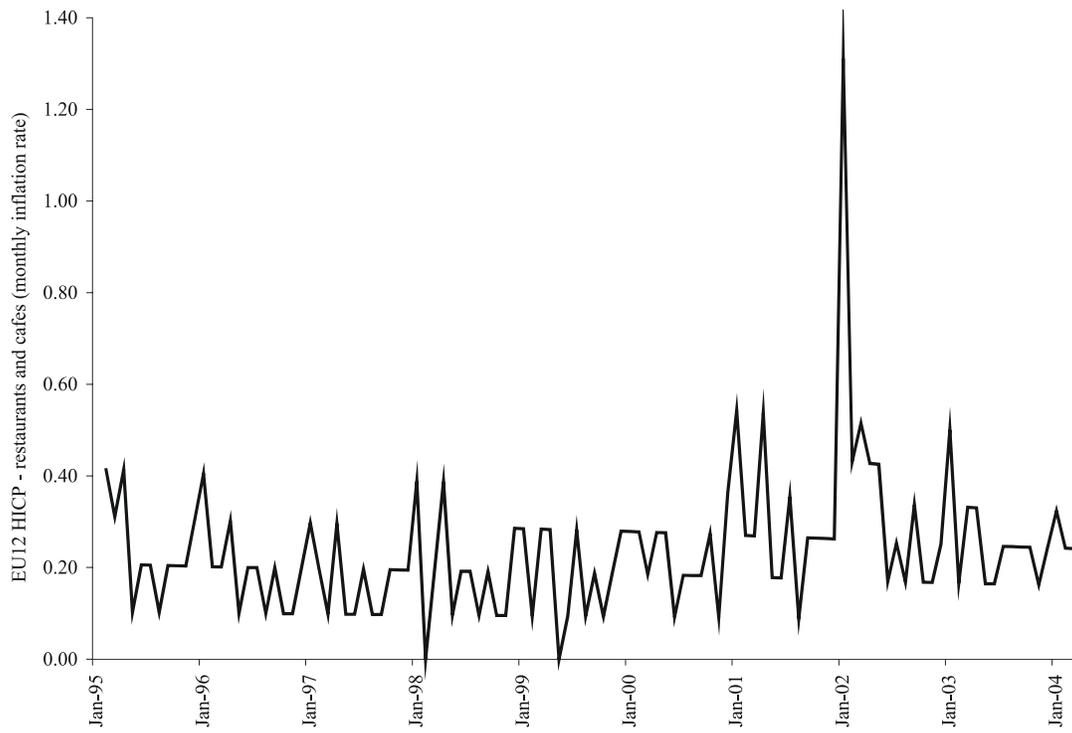
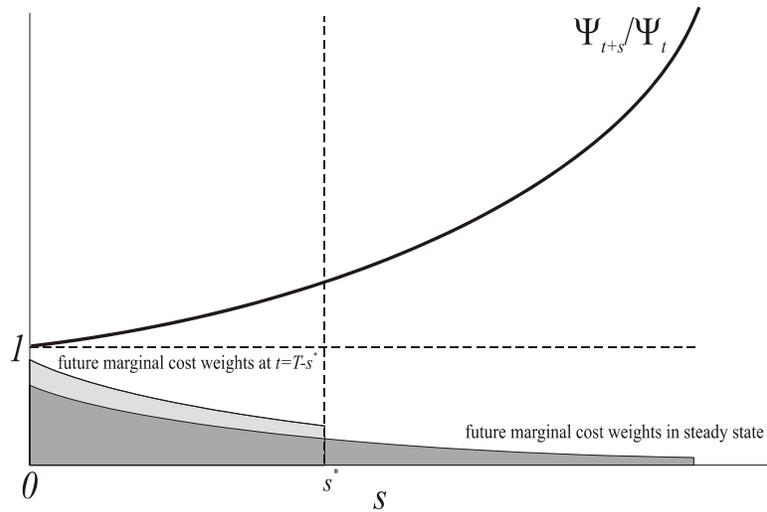
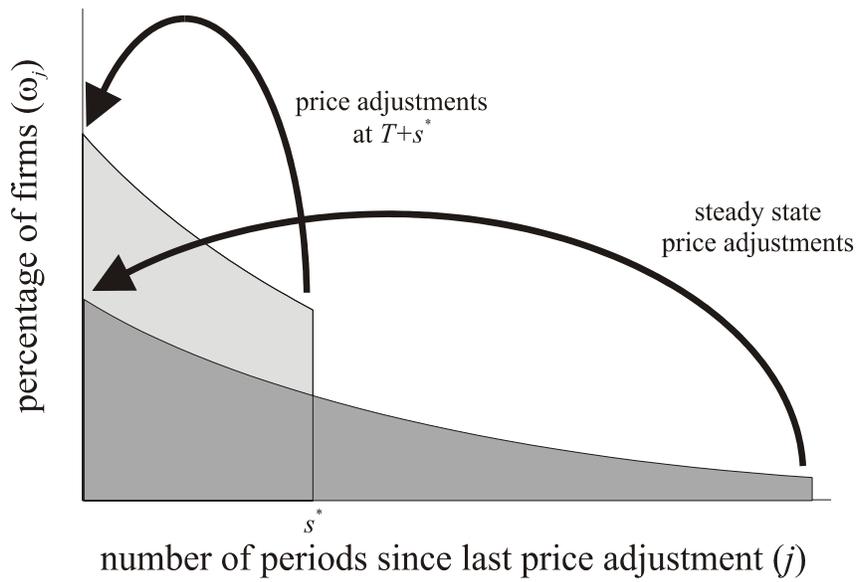


Figure II: EU12 inflation: Restaurants and Cafes



**I. Horizon effect**



**II. Distributional churning**

Figure III: The main mechanisms in the model's equilibrium inflation dynamics

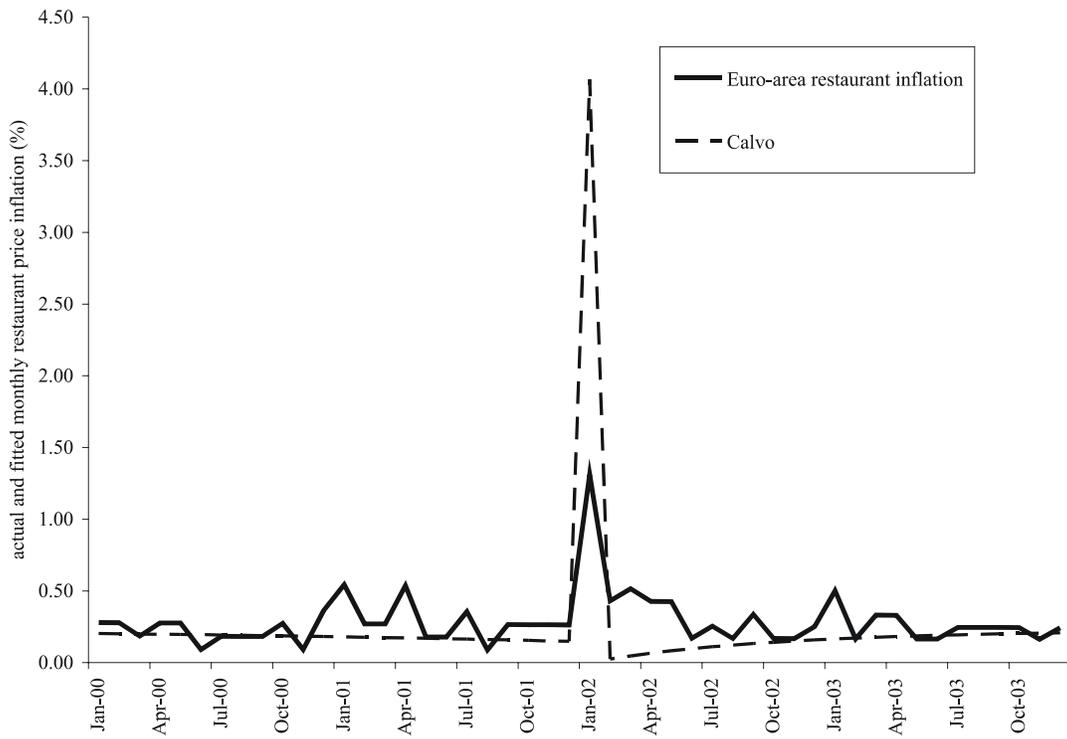


Figure IV: The Calvo model

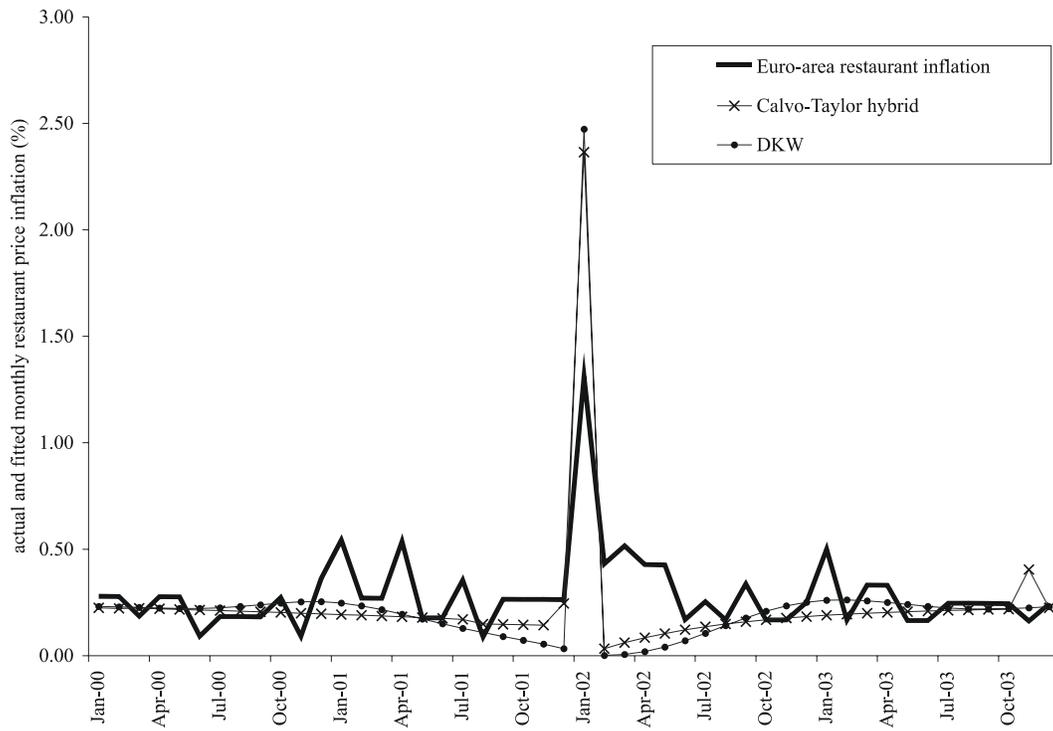


Figure V: Calvo-Taylor hybrid and DKW model

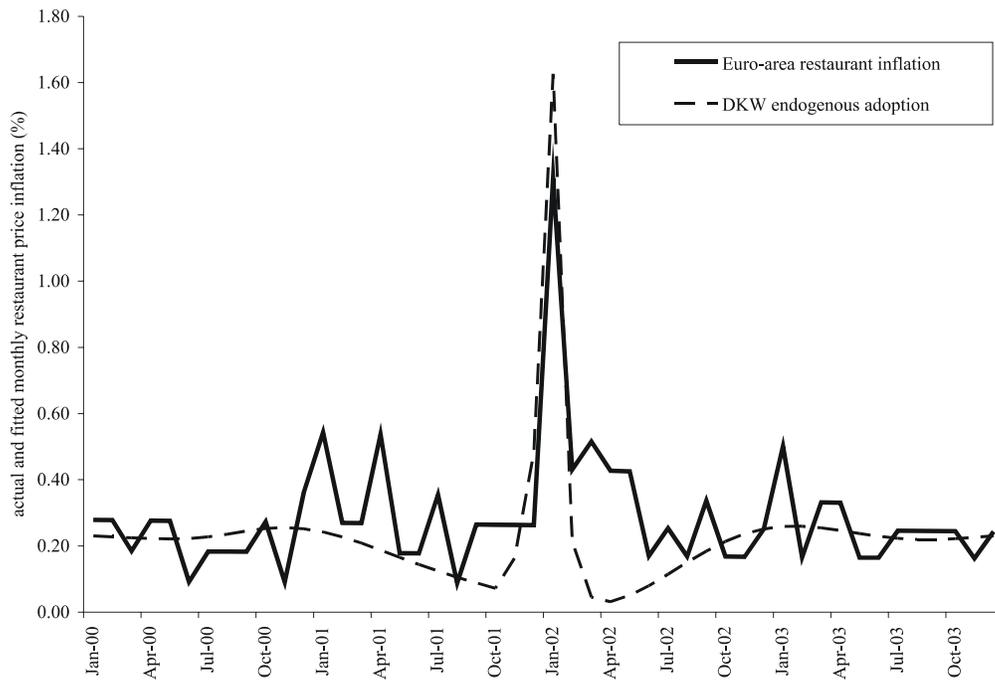


Figure VI: Augmented DKW model with endogenous adoption of the euro