The Money Illusion

Consumers are commonly subject to what economists call 'the money illusion', whereby a consumer's perception of the value of money is influenced by the nominal value of the currency. In other words, it's psychologically easier for an American consumer to buy a widget for one dollar in the US than it is for that same consumer to purchase the same widget while on a trip in Vietnam for 16,000 Vietnamese dong, the equivalent of one US dollar.

Recent research in economics and in marketing shows that consumers are willing to pay more for a given product when it is priced in a less numerous currency (such as the US dollar) than in a one that is more numerous (the Vietnamese dong).

INSEAD professors **Klaus Wertenbroch** and **Amitava Chattopadhyay** have taken a fresh look at this classic economic conundrum in a recent article published in the Journal of Consumer Research, co-authored with Dilip Soman of the University of Toronto.

"We were motivated by the introduction of euro currency in 2002 and the resulting perceptions of high levels of inflation in euro zone countries that had gone from high 'numerosity' national currencies to low numerosity euros (for example, 6.56 French francs or FF is approximately 1 euro), despite a fairly modest real inflation rate as measured by the European Central Bank (ECB)," says Wertenbroch. "Even though the real annual inflation rate for consumer prices in Germany has only been about 2 per cent since 2002, consumers have perceived it to be closer to 9 per cent."

In other words – contrary to commonly-accepted economic thinking about the 'money illusion' – most European consumers were feeling poorer after switching from their own more numerous currency to the less numerous euro. Wertenbroch and his colleagues discovered that previous research about the 'money illusion' had failed to account for the budgetary component of a consumer's decision-making process.

"In a number of experimental studies, we found that consumers evaluate transactions by how many nominal currency units they have left over in their wallet (or budget) after the transaction," Wertenbroch says. "Imagine going to the bakery with FF65 in your wallet and buying a baguette for FF6.50. You'd have FF58.50 left over after the purchase. Now imagine going with €10 in your wallet and spending €1 on the baguette. You'd have €9 left over.

Psychologically, the 9 euro currency units feel a lot less than the 58.5 French franc currency units. So you end up feeling poorer when both your budget and the price you pay are measured in a low – as opposed to high – numerosity currency. The existing research until now didn't look at the effect of taking your budget into account and so came up with different results."

Many of the specific references to the euro were deleted by the American journal which published the research paper. Wertenbroch feels that the implications of his research are vital for policy-makers in Europe, as anti-euro sentiment has been rising sharply in many European countries.
"I believe it is important for European consumers to understand that much of their ill will toward the euro may have been caused by their own psychology rather than economic facts. This psychology, of course, is a powerful driver of what may happen to the euro over time and may thus establish economic and political facts."

"I am very much concerned that negative perceptions of the euro may undermine the progress toward European integration that has been achieved over the last 50 years, which – in the end – is perhaps the key factor that can help Europe reclaim an important economic and political role in the modern world and ensure the well-being of its citizens."


Amitava Chattopadhyay is The L'Oréal Chaired Professor of Marketing - Innovation and Creativity at INSEAD.


Klaus Wertenbroch is Professor of Marketing at INSEAD.

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