"STICKY" PRICES

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U.S. manufacturers are often slow to change prices—either upward or downward—based on changing costs. Research by Professor Alan Blinder at Princeton University (and former Vice Chair of the Federal Reserve Bank) has indicated that there are often long delays in price changes—if they happen at all—even if the cost changes can be readily predicted.

One reason why manufacturers tend to be slow to pass reduced costs of production is the competitive dynamics of many markets. Sales will generally be somewhat lower at higher prices. Over a variety of categories, it has been estimated that the price elasticity of many goods is around -2, meaning that for every one percent price increase, the quantity demanded will tend to decrease by about two percent. This also works in reverse so that a one percent decline in price will tend to result, on the average, in about a two percent increase in the quantity sold. However, firms are often better off selling a smaller quantity at a higher margin than would result if the price were decreased.

If a manufacturer could decrease its prices while being guaranteed that competitors would not follow suit, that manufacturer might dramatically increase its sales because "cross-brand" elasticity is significantly higher than category price elasticity. That is, it is easier to motivate consumers to switch brands when one alternative is significantly lower priced than it is to affect the quantity consumed across the brands in the product category. In real life, however, manufacturers cannot control the behavior of competitors. Therefore, if one competitor lowers its price, other competitors are likely to follow. This, then, means that each manufacturer may end up with roughly the same market share but at lower prices. In turn, this means that manufacturers will generally try to avoid lowering prices until their competitors do. Technically, the optimal timing for a price reducing would be immediately before others make the price reduction.

In the case of current food prices, one reality is that although petroleum prices have declined somewhat recently, it is not certain that they will stay down in the long

run. There is a limit to how much petroleum can be produced and demand from developing countries—China and India in particular—has increased dramatically over the last several years. If the current global recessionary trend continues, it may take a while for prices to catch up, but they likely will over time. Manufacturers may fear that increasing prices later would have repercussions. If costs of manufacturing, over time, increase so much that an additional price increase will be needed, it is helpful to have a “head start.”

With the likelihood of a recession, it is possible that retailers will put pressure on manufacturers to decrease their prices. Large volume retailers—such as the large supermarket chains and discounters such as Wal-Mart—have considerable bargaining power. This, then, will change the competitive equilibrium among retailers since they can affect brand choices by their promotional choices and shelf space allocations.

Another factor that may influence the competitive balance is the growth of “private label,” or “store” brands, offered by retailers. Wal-Mart, for example, offers a number of products in various categories under the label “Sam’s Choice.”   In the cola drink category, there is some correlation between the Sam’s Choice and Coca Cola containers for variants such as regular and diet cola. So far, these store brands so far have captured only a small part of the U.S. market, but their share is growing. Retailers have a great deal of power to promote their own brands. Although these brands are sold at lower prices than are the national brands, retailers make larger profits because they do not face the same costs of brand building. Retailers can make the price differences quite salient by placing their own brands right next to the national ones and displaying signs indicating the savings. There is also a chance that, during a recession, more consumers will switch to the “intermediate” branding level “regional” brands. These factors, in combination, may spur on price cuts.