

Prevalence of Rigid Prices

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Price rigidity: prices do not fully respond to underlying shocks
Special case: fixed price

≠ Price flexibility: prices fully respond / absorb shocks

Data on frequency of price changes does not provide compelling evidence of price rigidity b/c it does not have any information about underlying shocks.

→ Without knowing anything about marginal costs, it is impossible to say anything about price rigidity or flexibility.

→ We must turn to evidence on passthrough (IO, trade)

Eyote, Madarasz, Michallak (2021) Passthrough of
marginal-cost change into price is incomplete, $< 100\%$

Comparison with Microevidence. The result that prices do not fully respond to marginal-cost shocks accords well with evidence on real firm behavior. First, using matched data on product prices and producers' unit labor cost in Sweden, Carlsson and Skans (2012) find a passthrough of idiosyncratic marginal-cost changes into prices of only 0.3. Second, using production data for Indian manufacturing firms, De Loecker et al. (2016, Table 7) find that following trade liberalization in India, marginal costs fell significantly due to the import tariff reduction, yet prices failed to fall in step: They estimate passthroughs between 0.3 and 0.4. Third, using production and cost data for Mexican manufacturing firms, Caselli, Chatterjee, and Woodland (2017, Table 7) also find a modest passthrough of idiosyncratic marginal-cost changes into prices: between 0.2 and 0.4. Last, combining production data for US manufacturing firms with data on energy prices and consumption, Ganapati, Shapiro, and Walker (2020, Tables 5 and 6) find a moderate passthrough of marginal-cost changes caused by energy-price variations into prices: between 0.5 and 0.7. Taking the midpoint estimates from the four studies, we find an average passthrough of $0.3 + 0.35 + 0.3 + 0.6 = 0.4$. Such cost passthrough is well below 1.

Overall, passthrough of marginal-cost
changes into price is $\approx 40\% < 100\%$

\rightarrow prices are somewhat rigid, but not
fixed.