

“Menu Costs, Strategic Interactions, and Retail Price Movements”

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Abstract

This paper examines a state-dependent pricing model in the presence of fixed adjustment costs of prices – menu costs. A model with menu costs has potential to explain an important characteristic of retail price movements: prices discretely jump. This paper shows that the assumption about market structure is crucial in identifying menu costs. Especially, prices in a tight oligopolistic market could be more rigid than those in more competitive market such as monopolistically competitive one. If so, the estimates of menu costs under the assumption of monopolistic competitions in the past studies are potentially biased upwards due to the rigidity from strategic interactions among brands. In addition, the estimate could be biased downwards without controlling for the benefits from unobserved promotional activities. Developing and estimating a dynamic discrete-choice model with multiple agents to correct these potential biases, this paper provides empirical evidence that menu costs as well as strategic interactions are important for explaining the observed degree of price rigidity in weekly price movements of typical retail products, graham crackers.