Countercyclical Average Price in Customer Market

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Abstract

We examine a customer market of a homogeneous good and show that the equilibrium average price may be countercyclical for two reasons. The first reason is that in times of high demand, sellers' reputational concerns may increase, causing them to offer extra discounts. The second reason is that buyers' search incentives may increase, causing buyers to become more price sensitive. The two reasons are interdependent in a manner not yet considered. The model developed is a two-period extension of Reinganum's model. Our explanation nests two previous hypotheses in the literature and raises the possibility of multiple forces jointly generating countercyclical price movement. Also, it is shown that while the average price falls, price decreases may differ across sellers according to their types. Specifically, high-cost sellers tend to reduce their prices by larger amounts than low-cost sellers during peak demand periods. This insight is new in the theoretical literature and accords with the evidence of a recent empirical study.

Keywords: countercyclical price, price dispersion, search, repeated purchase
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