Inflation, market power and cost price pass through

Prof. dr. J. Hinloopen
J.Hinloopen@uva.nl

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Jeroen Hinloopen

- Professor of Economics at UvA, specializing in Industrial Organization
- Member of the Board, Centraal Planbureau (CPB)

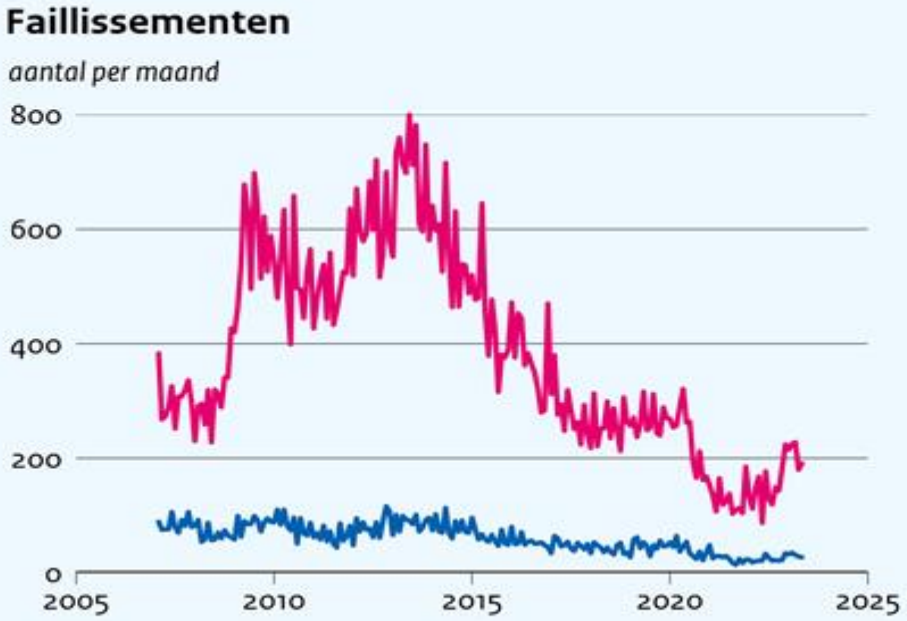
Today's program

- Current economic developments
- Inflation: past, present and (near) future
- Inflation and procurement
- Market power and cost price pass through
- (The price-wage spiral)

Current economic developments

- Geo political tensions (local economic consequences)
- Tight labour markets
- Faltering fiscal discipline (US debt ceiling)
- Significant and persistent inflation
- Rapidly increasing interest rates
- Gradual transition post-covid economy
- Towards stabilizing perceived uncertainty

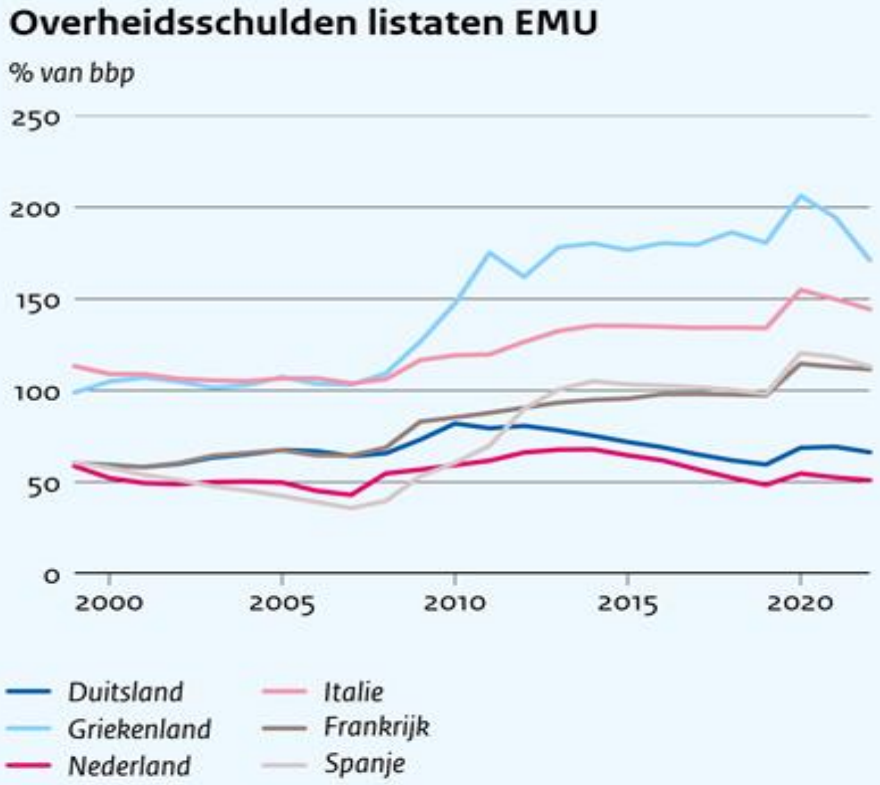
Current economic developments

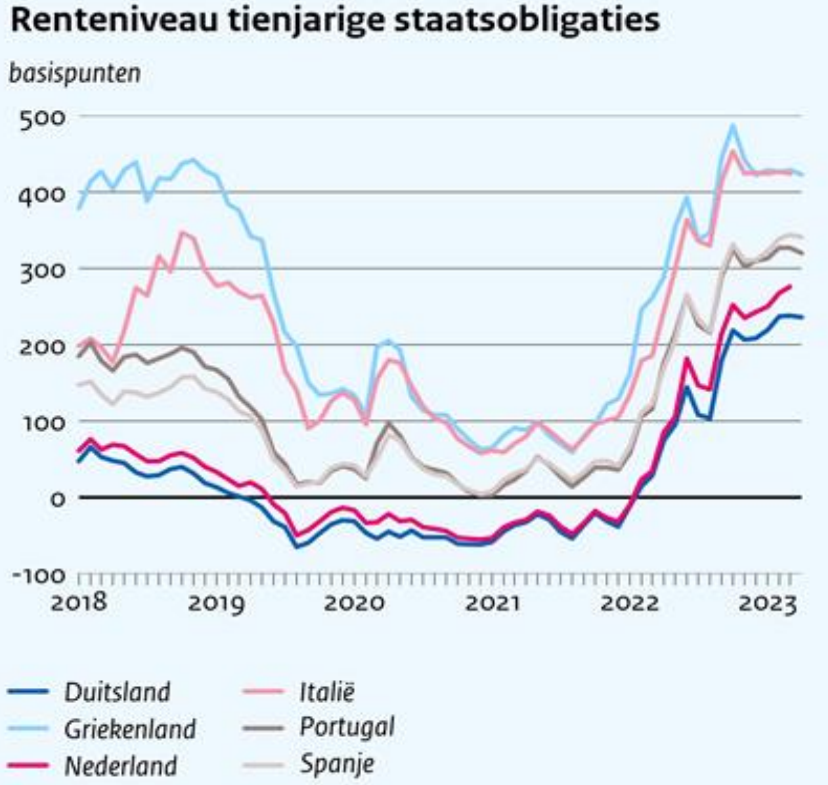




Source: CPB Financiële Risicorapportage 2023

Current economic developments





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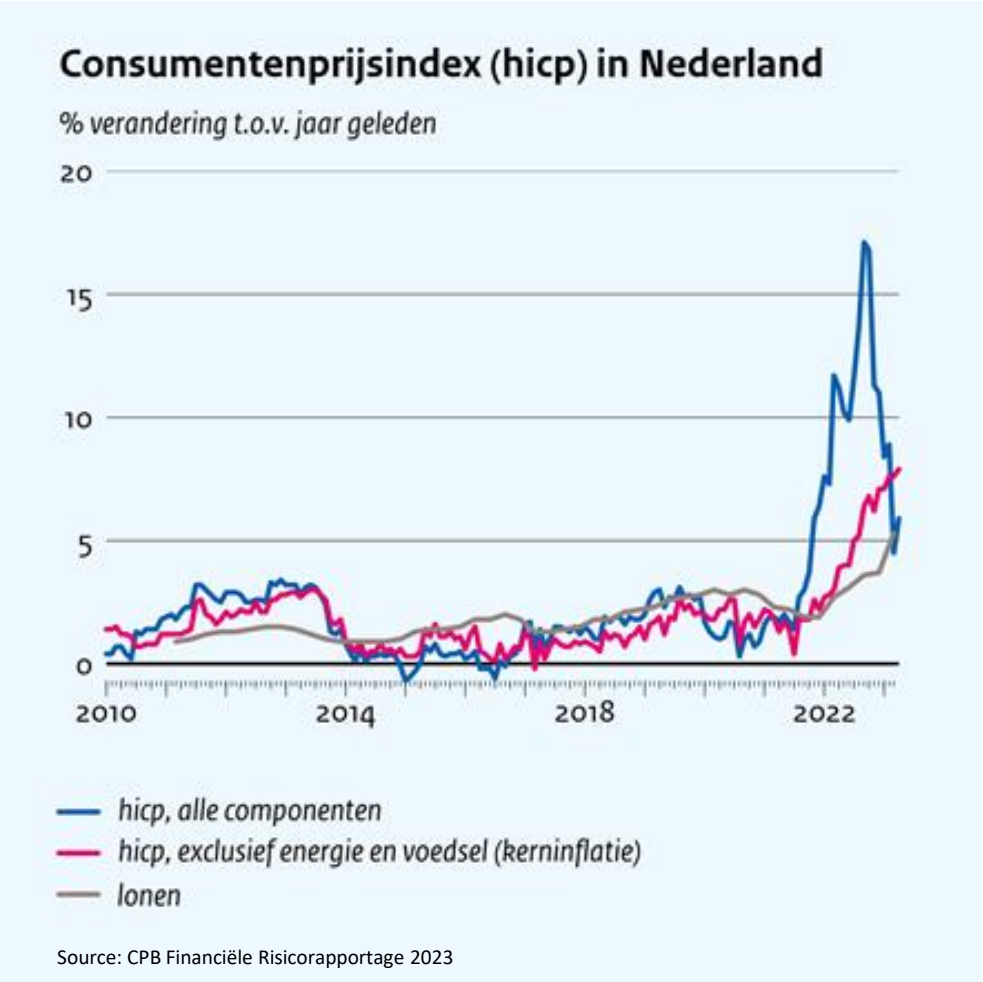
Inflation: past, present and (near) future



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Inflation: past, present and (near) future

Sources of inflation:

- Monetary policy:
  - Sinds 2008 ECB has implemented a loose monetary policy, targeting 2% inflation
- Demand increase:
  - Post-covid spending
  - Generous government support programs
- Cost increase:
  - War in Ukraine
  - Restructuring post covid (e.g. shipping costs)
  - Wage catch up

Policy: government programs counter monetary policy (interest rate increases)

Inflation and procurement

- Go to menti.com, enter number 3857 7876

Inflation and procurement

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- Procurement affects inflation in two ways:
  - Cost increases can yield higher consumer prices (cost price pass through)
  - Demand increases can yield higher input prices (market power multiplier)

Central question: What is the role of market power?

Market power and cost price pass through

Christos Genakos and Mario Pagliero (2022), "Competition and Pass-Through: Evidence from Isolated Markets." *American Economic Journal: Applied Economics* 14(4): 35–57

Setting:

- Daily gazoline prices in 2010 on 33 different Greek islands
- Variation in number of gazoline stations, ranging from 1 (1.100 inhab.) to 7 (9,800 inhab.) (average price 1 liter diesel: €0,96 (monopoly), € 0,93 (7 suppliers))
- Three sudden and direct increases in excise taks (price 1 liter unleaded 95 petrol: € 0,41 → € 0,53 → € 0,61 → € 0,67)

Question: What is the relation between competition and cost price pass through?

Results:

Market power and cost price pass through

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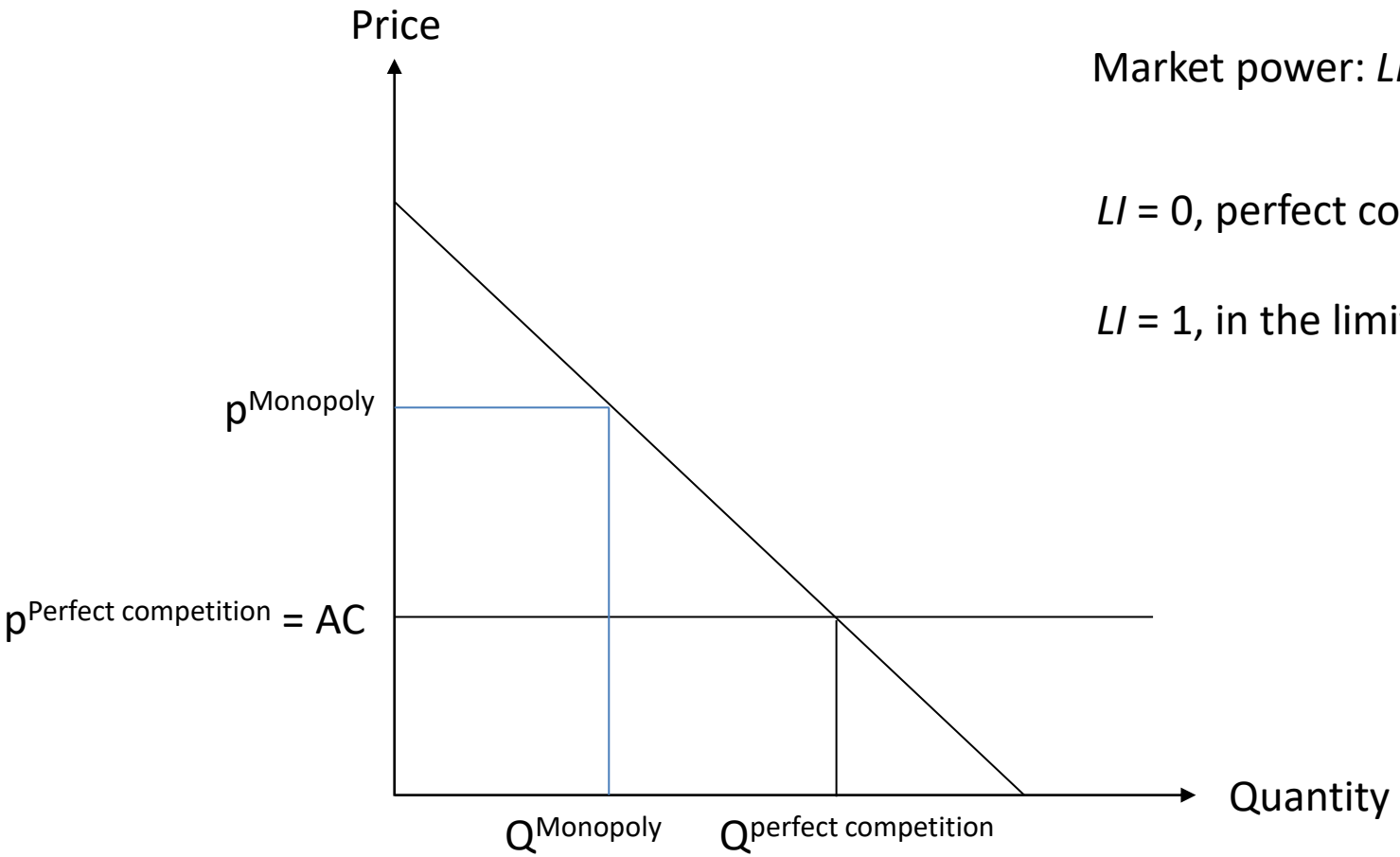
Results:

- Pass-through varies: from 43% (monopolist) to 100% (> 4 competitors)
- Pass-through is rapid: 71% of final cost increase pass-through after 10 days

Market power and cost price pass through



Market power: $LI = \frac{Price - AC}{Price}$

LI = 0, perfect competition

LI = 1, in the limit

Market power and cost price pass through

More market power induces *less* of a cost increase to be passed on to consumers:

- Absent market power, the supplier has no choice other than 100% pass through

Alternatively:

- More market power yields higher prices
- A further price increase reduces demand relatively more (relatively high demand elasticity)
- Also: existing margin can absorb the cost increase.

This is coined the ‘cost transfer paradox’

The price-wage spiral

Current policy debate: Fear for triggering a wage-price spiral.

Question: what, if any, is the role of market power in this spiral?

So far: more market power, less of a spiral due to the cost (wage) increase.

However: a wage increase triggers a demand effect.

By the same logic: more market power induces *more* of a demand increase to increase prices:

- Under perfect competition only (total) supply increases
- High price elasticities trigger strong price reactionsg

Thus: the relation between market power and the likelihood of a price-wage spiral is ambiguous