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Guo Chen, C. Gizem Korpeoglu, Stephen E. Spear

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Price Stickiness and Markup Variations in Market Games

Guo Chen

Department of Economics, University of Kansas, Lawrence, KS, USA 66045, chenguo@ku.edu

C. Gizem Korpeoglu

University College London, School of Management, London, UK, E14 5AA, c.korpeoglu@ucl.ac.uk

Stephen E. Spear

Tepper School of Business, Carnegie Mellon University, Pittsburgh, PA 15213, ss1f@andrew.cmu.edu

In this paper, we show that the Shapley-Shubik market game model with production naturally generates an equilibration mechanism that can accommodate price stickiness arising from strategic interactions of firms. Unlike New Keynesian models that show similar price stickiness results, the market game model does not require enforcing menu costs or other additional restraints on price adjustment mechanisms in order to generate price stickiness. As such, we suggest that the market game model can provide a good micro-foundation for macroeconomic analysis. We then explicitly show the relationship between a typical firm's markup of price over marginal cost and its market share.

Key words: General Equilibrium, Market Game, Price Rigidity.

JEL Codes: D43, D51, E12.

1. Introduction

Contemporary macroeconomic theory has been built on the three pillars of imperfect competition, nominal price rigidity, and strategic complementarity. The stickiness of prices (and wages in particular) is a well-established empirical fact, with early observations about the phenomenon dating back to Alfred Marshall. Because the friction of price stickiness cannot occur in perfectly competitive markets, modern micro-founded (e.g., New Keynesian) models have been forced to abandon the standard Arrow-Debreu paradigm of perfect competition in favor of models where agents may influence market prices. Strategic complementarity enters the picture as a mechanism for explaining the kinds of coordination failures that lead to sustained slumps like the Great Depression or the aftermath of the 2007-2008 financial crisis. Early work by Cooper and John (1988) lay out the importance of these three features for macroeconomics.

The need for imperfect competition becomes particularly transparent when one notes the importance of firms' markups of prices over marginal costs in allowing for quantity adjustments independently of price adjustments in response to market shocks. This is because prices equal marginal

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