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Stuck Like Glue

By Trace Dixon

In the Economic world, we have a very official term for when a price point is resistant to change, in particular, dropping to a lower, cheaper price point more in line with a new equilibrium, something that has nominal rigidity. Since we are already throwing around words and phrases such as “equilibrium” and “nominal rigidity,” you would assume this term would have a very serious, sophisticated name – one carefully created by global academics and economists. It certainly would not be something that sounds silly like “Sticky Prices” right?

Well, you can’t expect everyone to have the creative gene, or things such as wild imaginations! You’ll have to believe me as a recovering Economics tutor, our department rarely received awards for best whiteboard drawing! Sticky Prices are when a when the cost of a good or service changes, but the price charged by those selling the good or providing the service just won’t budge. This is most commonly seen and referred to in the real world when prices won’t go down despite an adjustment in cost. An example we all are aware of today: the price at the pump for a gallon of gas.

To help us understand sticky prices, we’re going to flesh out that example starting by saying you are the owner of a gas station. To do business, it costs 50¢ per gallon for you to purchase gasoline to dispense. You pay an additional 50¢ per gallon sold to your employees as wages, $1.00 per gallon sold to cover overhead and rent, and 50¢ per gallon sold for all your utilities and additional expenses. Since added together it costs you $2.50 per gallon to do business, you decide to charge your clients $3.00 per gallon so that you can keep 50¢ per gallon as profit!

Everything is going well, until one day you receive word gas costs are going up to $1.00 per gallon. You care for your customers and do not want to raise the price, but that increase is going to wipe out your margin and leave you on the edge of not being able to pay your bills! So, you raise the price to $3.50 for your clients to pay for a gallon of gas, leaving the customers to help you pay for the increase in costs and maintaining that 50¢ per gallon margin for you and your business.

Then good news comes down the road! You find out the next shipment of gasoline will be going down to 75¢ per gallon. It’s not where you were before, but it’s better than you are now. You go out at the end of the day to change the sign when an idea crosses your mind: What if you left the price up another day? There’s nothing that says that you have to maintain a 50¢ margin. Supply is not short, so it cannot be considered gouging, no competitors in your area have taken care of your clients like you do, plus the cost of gasoline might go back up, who knows! So, you leave the price at $3.50 and for that day you bring in a profit of 75¢ for every gallon of gas sold! One day becomes one week, one week becomes two, and in the meantime the cost of gas goes down again back all the way down to 50¢ per gallon. You are making more money than ever and after a few weeks you finally bring the price down, now having that extra money you made to use however you please!

Now we scale that out to not just the gas stations, but every business on the block. All businesses can become subject to inflation, and all of them take their time coming down, often because for a moment the margins are better than ever and are easily justified and managed. The free market always wins in the end, that's why we call them sticky prices and not stuck prices! But for a while, we have to sit back and wait for everything to come back to Earth and hope they stay. Prices shoot up like a rocket and drop like a feather.

So why (besides recent reheating in the war with Iran) has the price of oil gone down while the price of gas at the pump has barely moved? PRICE STICKINESS! Keeping that in mind, how do we address it, and is there any back-end benefits to it?

As we mentioned a bit ago, free market economics states the best medicine for sticky prices is a healthy dose of competition and a desire from those competitors to gain market share through doing business the best way possible: providing a needed product at a price people want while caring for the providers (employees) and the purchasers (customers). All of those together create profit, as well as alliteration that would make a Southern Baptist Preacher jealous! If a new gas station was trying to gain business down the block and was subject to paying the same cost for a gallon of gasoline, it could lower its prices faster in hopes of attracting more business. And in response, you would lower your price down to keep in line as you wouldn't want to lose your business to a competitor. We, as American citizens, can lobby our leaders to maintain and support the free market while also supporting the businesses that do it best, as the incentive of sales is the main method of moving the market!

As far as back-end benefits, we actually can net some positives in the short term. If you are invested in the stock market, an increase in profit margin can improve a balance sheet which in turn can bolster better dividends, better company financial health, and improve stock price appreciation. These are beneficial in the short term; however, such benefits do get outweighed over time by inflated prices sitting above their equilibrium, or that magic point of the lowest price someone is willing to sell and the highest price someone is willing to spend. To tie it back into our example, we can gain some short-term benefits from owning stock in oil and gas companies, but in the long-term, the higher price we are paying for gas tends to outweigh the benefit we're receiving through the potential of better returns.

Regardless of how inflation works out, we always have to remember what we can control the most, and that is our budget and how we chose to spend our money. Economic principles will come and go, and there's little we can often do about them. But we can choose where we spend our money and how we spend our money, which means we can stay above sticky inflation and support the businesses that support their customers. And that is the attitude that keeps the free market free indeed.

Please remember to notify us if you have had any material changes in your financial circumstances.