

Cyclical Movements In Markups: The Role Of Cost Pass-Through

Harry Bloch
Michael Olive

Difficulties in measuring marginal cost frustrate the analysis of firm markups. In recent years, implicit measures of markups using the Solow residual have gone some way to meet this problem. Yet the markup is often presented as a function of aggregate demand and industry specific cross-sectional variables. This ignores the role of cost in determining markups. Here, a pricing equation is developed that implicitly measures the rate of change in markup as a function of aggregate demand growth, aggregate inflation and firm marginal/average cost inflation. This is applied to 21 two-digit SIC industries in the U.S., for the period 1948 to 1979. The results show that there is incomplete pass-through from cost into price, and a negative relationship between cost and the markup, in all industries. Also, aggregate inflation has a positive influence on prices and markups. Tests provide evidence of omitted variable bias when cost inflation and aggregate inflation are left out of the estimating equation. When these variables are included along with aggregate demand growth, estimates show that aggregate demand has a negative influence on price and the markup in high concentration industries but no significant influence in low concentration industries.

JEL Codes: E32, L13, L16.

Keywords: aggregate demand, price-cost markups, Solow residual.

Correspondence:

School of Economics and Finance
Curtin University of Technology, Perth
Australia.
olivem@cbs.curtin.edu.au