'Superstar firms' fuel price volatility

Shifts in structure of product markets complicate central banks' job

by Pierre Ortlieb in London

Wed 13 Mar 2019

Shifts in the nature of product markets have made it significantly harder for monetary policy-makers to fulfil their mandates. A blend of globalisation and technological advances has allowed a small number of firms to dominate their industries. These 'superstar firms' operate in global value chains, reap economies of scale and network effects, and monopolise industry sales. Rising cross-industry sales concentration levels, the accumulation of patents by a small group of companies, and declining labour shares of income suggest a decline in competitive pressures across product markets.

At the same time, firms have more market power, while prices are more volatile and inflation shocks spread more easily. Online competition, and algorithmic pricing technologies in particular, have altered retailers' pricing behaviour. For instance, at retailers such as Walmart, the time in which prices stay unchanged has fallen to 3.7 months from 6.5 months since 2008. Concentration in the financial industry has added to this. As financial institutions have become involved in commodities markets over the past few years, their involvement has produced a distinct, inflationary shock in these markets. Macroeconomic inflation dynamics are fundamentally shifting. This is particularly true in the US, where industry-level concentration has been the most pronounced.

These changes complicate the job of monetary policy-makers and muddle the transmission of inflation policy via prices. First, companies with a high degree of market power are likely to produce output below optimal levels. When this takes place in product markets, policy-makers may be tempted to loosen monetary policy to an unnecessarily high degree, as the structural changes taking place limit their ability to gauge adequately the nature of the economy. This is exacerbated by the advent of ecommerce platforms, which have introduced a significant rise in inflation variability. By automating pricing decision using algorithmic technologies, online retailers are able to make rapid pricing changes in response to economic shifts or competitors' decisions. As these practices become more widespread, it is unclear how future price changes will be perceived and felt throughout an economy. This brings significant risks and uncertainty into policy-makers' monetary calculus.

Second, much as an increase in a company's market power produces distorted output outcomes, it may also reduce a powerful company's investment rate. A decrease in industry level competition leads to a stagnation in investment, even in low-interest rate environments like that of the past decade. Rather than investing, large firms with concentrated power tend to spend disproportionate amounts of liquidity buying back shares. This lowers the neutral rate of interest at which GDP is growing on trend, resulting in downside risks and uncertainty if policy-makers inadvertently raise rates excessively.

This set of shifts in the structure of product markets complicates the task of central banks and economic decision-makers. In response, they may continue to guard aggressively against inflationary risks in the face of structural uncertainty and doubt over key policy variables. However, the evolving nature of price dynamics in advanced economies suggests that fiscal or regulatory authorities should be brought into the fold to achieve price stability. Inflationary pressures resulting from the monopoly power of a 'superstar firm', for example, might be better mitigated through alternative tools such as administrative agencies rather than interest rate increases and reduced aggregate demand.

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