

DEMETRIS KOURSAROS

Cyprus University of Technology, Cyprus

SALES AND PROMOTIONS AND THE GREAT RECESSION DEFLATION

Abstract:

This paper investigates the effect of sales and promotions on the pricing decisions of firms. This study provides a theoretical model where firms face menu costs when adjusting their price and apply sales offers that decrease temporarily the listed price to attract higher demand, especially because households exert effort to locate the price deals. Thus, each period the final price is determined by the price set by the firm which is common knowledge to all agents and a sales deal that is a draw from a distribution with endogenous time-varying support. In a recession, even though prices in the economy look sticky, firms increase the frequency and the range of sales on their products substantially. This implies that traditional inflation measures are overstated in recessions, because they ignore the surge in sales and promotions and the consumers' tendency to hunt those limited time offers more actively. This framework can explain the mild deflation experienced during the Great Recession. Moreover, it is demonstrated that using traditional inflation measures can prolong recessions.

Keywords:

Sales and promotions, deflation, menu cost, discounts.

JEL Classification: E30, E31, E52