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The Simple Economics of Asymmetric Cost Pass-Through

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Abstract In response to cost changes, prices often rise more strongly or quickly than they fall. This phenomenon has attracted attention from economists, policymakers, and the general public for decades. Many assert that it cannot be explained by standard economic theory, and is evidence for "anti-competitive" behaviour by firms. This paper argues against this conventional wisdom; it shows that simple price theory can, in principle, account for such asymmetric pass-through - even with perfect competition. From a policy perspective, knowledge of cost pass-through patterns in a market does *not* allow for strong inferences on the intensity of competition.

Keywords Asymmetric price transmission, cost pass-through, electricity markets, price theory, rockets and feathers

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