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Why Prices Need to Change

A serving of Coca-Cola cost a nickel for 60 years–from 1886 into the mid 1940s– an example that illustrates the disadvantages of price stability, writes financial journalist Tim Harford in Slate. Low inflation helps companies and people plan their finances far into the future. But it also makes it harder for the prices of products to change relative to each other. If they can't do so, the economic consequences can be serious. Prices won't accurately reflect a product's demand and the cost of producing it. If, for example, the relative price of a car "can't fall when demand does, sales will collapse." If wages can't fall in a recession, unemployment will rise.

The case of Coke, Mr. Harford, is an extreme but useful example of the main reason that companies often choose to keep prices constant in the face of dramatic rises and falls in costs: the hassle involved of changing a product's price can be very high. The cost of reprinting a menu and sticking new prices on the shelves can be enough to deter a company from a price change Researchers have found that most prices change roughly once a year and one of the advantages of inflation is that it forces companies change their prices more often, making them more likely to reflect their true price relative to other products.

Coke kept its price constant even as the price of sugar tripled after World War I and then fell slightly and it went from being taxed as a medicine and then as a soft drink. Part of Coke's problem was that it sold many of its bottles in vending machines that only accepted nickels. A price hike would have meant either building new vending machines or doubling the price of Coke to a dime, neither of which made financial sense. The financial straight-jacket that coin-operated vending machines imposed on Coke was such that "the boss of Coca-Cola wrote to his friend President Eisenhower in 1953 to suggest, in all seriousness, a seven-and-a-half-cent coin," says Mr. Harford.

These costs can still make a difference in an age when Coke can reprogram its vending machines easily and Internet retailer Amazon can adjust its prices whenever its costs change, writes Mr. Harford. A few companies that are slow to adjust prices can still severely distort the prices of companies that are quick to do so. Even if Amazon can constantly tinker with the prices of its books, it still has to reflect the less flexible prices that appear further down the product chain with shipping companies and bookbinders. ***— Robin Moroney***

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