Learning Quality from Prices and Word-of-Mouth Communication

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Abstract
I consider a two-period model in which a monopolist introduces a new experience good of unknown quality to consumers. Consumers learn in equilibrium from both prices and word-of-mouth communication. When the seller is better informed about the characteristics and quality of the product, the price provides a signal from which consumers can infer the firm's type (and therefore the quality of the product), even as it influences the rate of information transmission among consumers via interpersonal communication. The main result is that in any separating equilibrium the high-quality monopolist signals high quality through a low introductory price (lower than the monopoly price), whereas the low-quality monopolist charges a higher introductory price (the monopoly price). The intuition is simple: low prices are costly, and will only be used by firms confident enough that increased experimentation (and therefore communication among consumers) will yield good news and therefore increased future profits. Moreover, for the high-quality seller, the expected price (quantity) dynamic is increasing (decreasing) over time; whereas for the low quality one the opposite is true. Finally signaling becomes more difficult when consumers pay less attention to their peers' reports and more to past prices.

Keywords: Price Signaling, Word-ofMouth Communication , Monopoly
Jel Codes: : L12, L15, D21