Discussion of

"Can Supply Shocks Be Inflationary" by L'Huillier and Phelan

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Empirical premise: Demand shocks have small effects on inflation (Phillips curve is flat) but supply shocks have large effects (e.g., oil prices, chip shortage).

Puzzling because sticky-price models that explain small effects of demand also imply small effects of supply shocks.

For example, suppose staggered nominal price adjustment and "real rigidity" (firms don't want to change their relative prices). Then prices adjust slowly to shocks; applies equally to demand and cost shocks.

I agree there's a puzzle for standard models... although the paper somewhat exaggerates how "incredibly flat" the PC is.

----------BLM quarterly graph of V/U vs. median

To resolve the puzzle, the paper presents an interesting theory based on asymmetric information about demand shocks.

One suggestion:

The model assumes some consumers are uncertain about their own future preferences, which firms know. This is unappealing.

Instead, might assume a shock to income that is partly aggregate and partly idiosyncratic (like Lucas and earlier work by L'Huillier). Would we get essentially the same results?

An alternative resolution of the puzzle: consumer views on when it's fair to raise prices.

Kahneman, Knetsch, and Thaler (1986)

85% of people think it's unfair to raise the price of a shovel during a snowstorm.

79% of people think it's fair for a grocery store to raise the price of lettuce if the wholesale price has risent.

Anna's Taqueria understands this.

This story differs from L'Huillier's theory based on rationality and imperfect information.

An alternative view of what kinds of shocks are inflationary: aggregate vs. sectoral shocks.

Suppose demand and cost shocks vary across sectors, and some shocks are very large (e.g., increases in oil prices, chip shortage, decrease in travel during pandemic).

Assume menu costs –> degree of price rigidity is endogenous (not Calvo model). Then large shocks cause large and quick changes in prices in affected industries, with sizable effects on aggregate inflation.

Might study in an extension of L'Huillier's model with sectoral shocks.

Empirical relevance suggested by decomposition of headline inflation into weighted median inflation and deviations from median. The latter capture effects of large sectoral shocks.

---------graph of median and headline.....

In this story, aggregate shocks have modest effects on inflation regardless of whether they are demand or supply shocks (e.g., aggregate productivity shocks have modest effects).

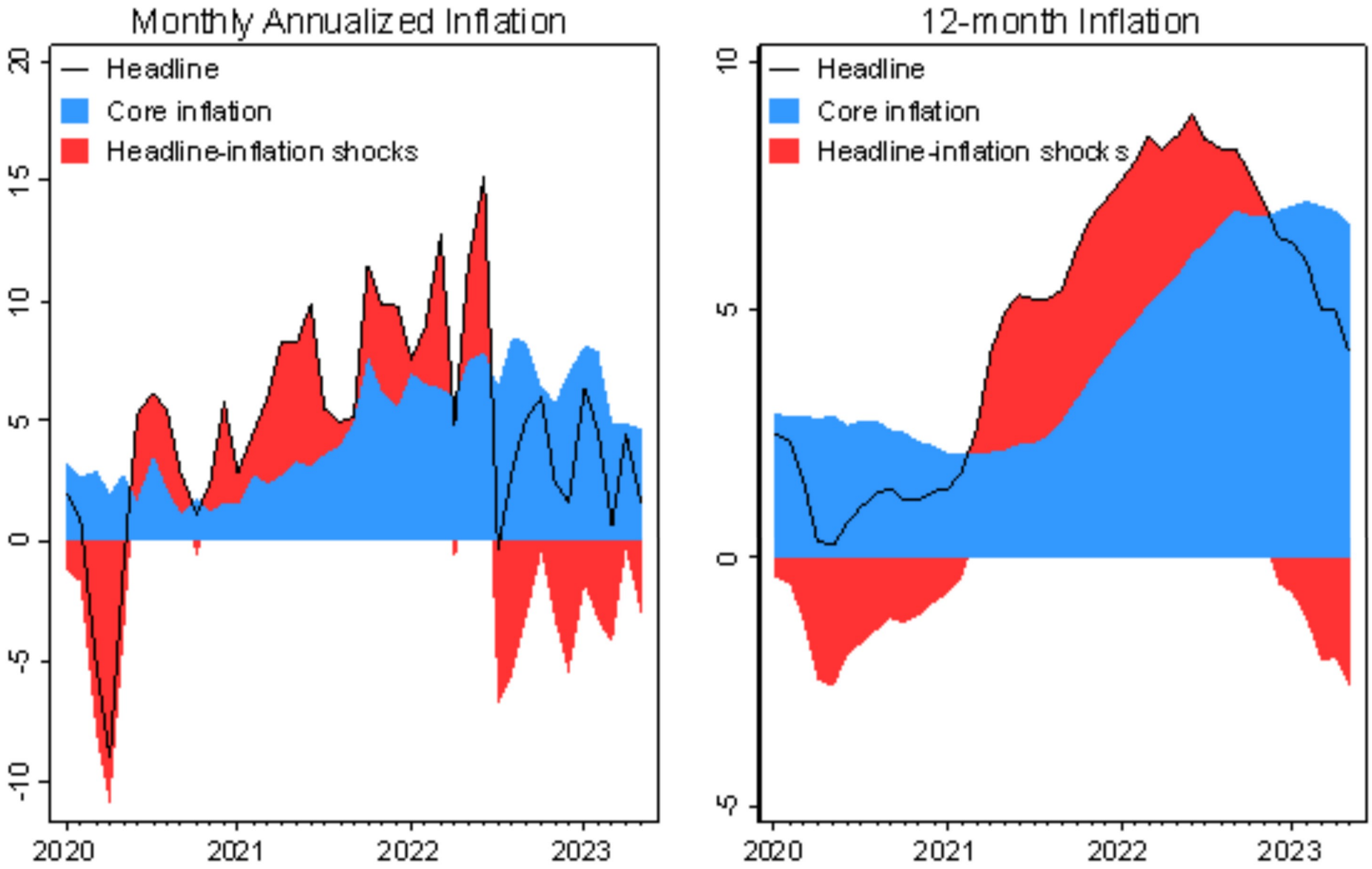
Large sectoral shocks have sizable effects on inflation regardless of whether they are demand or supply shocks (e.g., decrease in demand in travel-related industries in Spring 2020).

Future work might test whether effects of shocks vary based on demand vs. supply (L'Huillier view) or based on aggregate vs. sectoral.

A final thought inspired by the paper's analysis of cost shocks and imperfect information...

Can these ideas help explain "greedflation" and profits during the recent high-inflation episode?

It is acceptable to raise prices when costs rise... Consumers know there have been large cost shocks but don't perfectly observe where the shocks occur... Firms can get away with price increases because consumers attribute them to cost increases even if they really reflect higher markups.


Monthly Annualized Inflation
Headline
Core inflation
Headline-inflation shocks
20
15
10
5
0
-5
-10
2020
2021
2022
2023
12-month Inflation
Headline
Core inflation
Headline-inflation shocks
10
5
0
-5
2020
2021
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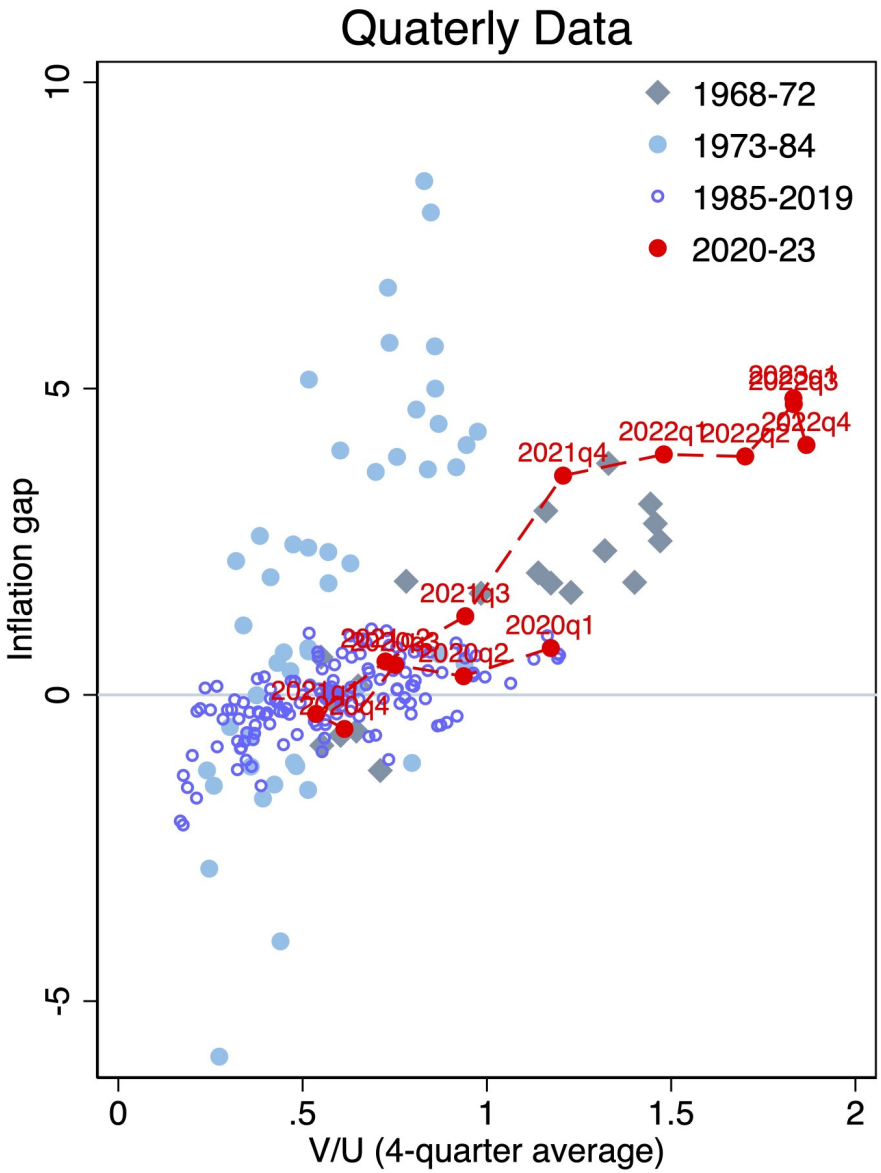
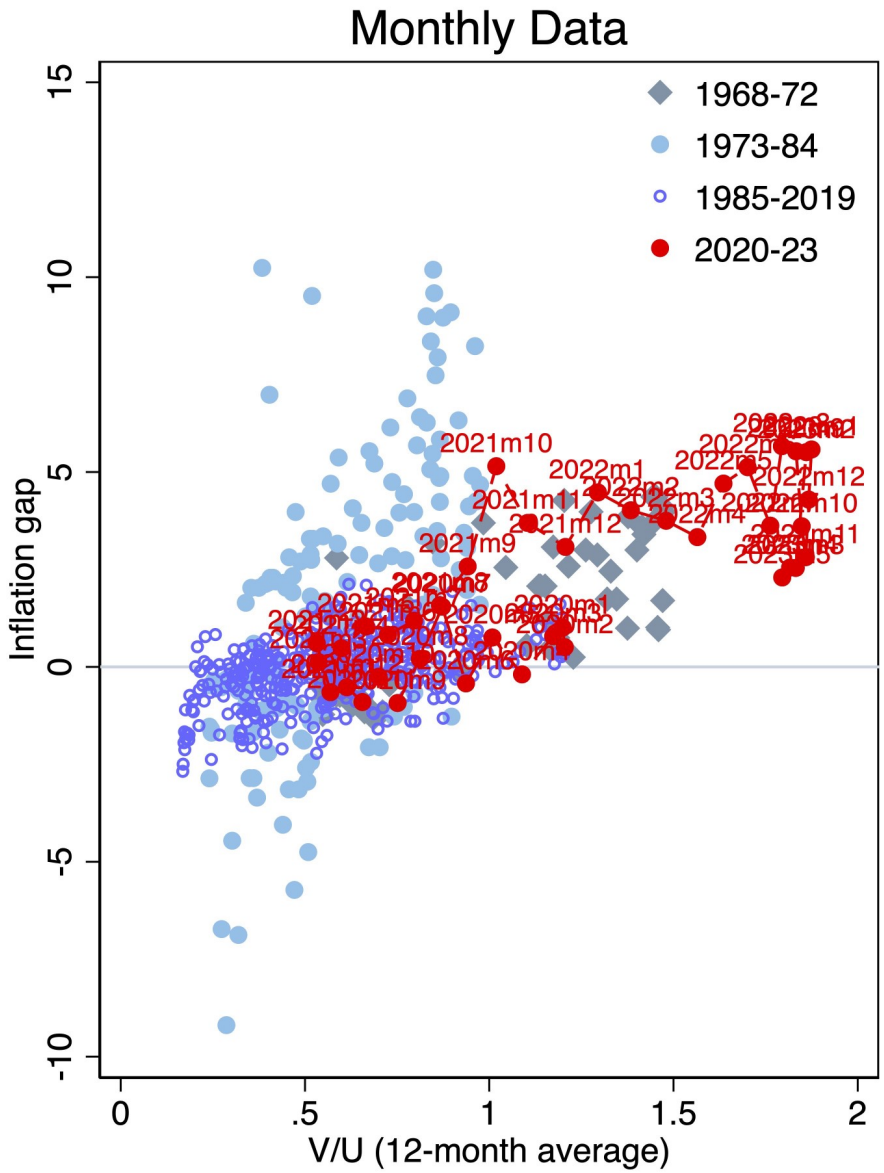
2023


Quaterly Data
1968-72
1973-84
1985-2019
2020-23
Inflation gap
V/U (4-quarter average)
2020q1
2020q2
2021q3
2021q4
2022q1
2022q2
2022q4


Monthly Data
1968-72
1973-84
1985-2019
2020-23
Inflation gap
V/U (12-month average)
2021m10
2022m1
2022m12