Business Cycles with Pricing Cascades

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     Challenge: *NKPC with a realistic slope requires implausibly large shocks* (L'Huillier and Phelan, 2025)

  ii. Fluctuations in the **frequency of price adjustment** (Montag and Villar, 2025; Gautier et al., 2025) ▸ Show

     Challenge: *a fixed menu cost model matches that at the cost of an implausibly steep NKPC* (Blanco et al., 2024)

  iii. Importance of **sector-specific** drivers of inflation (Schneider, 2025; Shen et al., 2026)

     Challenge: *need to allow for large sector-specific shocks in a setting with menu costs*

- Develop a **dynamic quantitative** general equilibrium model that features: a number of **sectors interconnected by networks** with **state-dependent pricing** that is solved **fully non-linearly**

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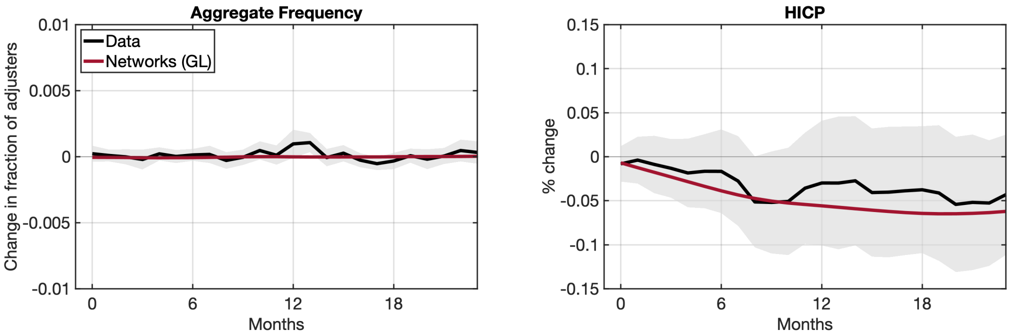
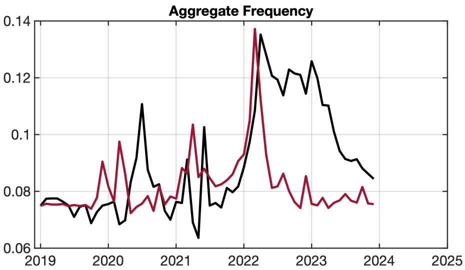
- **Supply shocks** (Agg./sectoral) **Networks speed up** the extensive margin adjust.: **cascades amplification**
  i Networks amplify the desired price changes, hence firms are more willing to pay the cost of adjustment

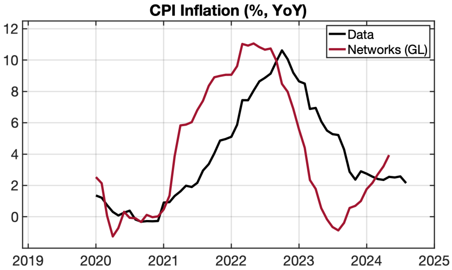
  ii Quantitatively, creates frequency increases and inflationary spirals following aggregate TFP/markup shocks, or TFP/markup shocks to sectors that are **major and concentrated** suppliers to the rest of the economy

Model performance: Euro Area monetary shocks



Model performance: Euro Area (post-)Covid inflation





MODEL

Model overview

- **Timing**: infinite-horizon setting in discrete time, indexed by $t = 0, 1, 2, ...$
- **Households**: continuum of identical households; consume output and supply labor
- **Firms**: continuum of monopolistically competitive firms, each belongs to one of N sectors, indexed $i \in \{1, 2, ..., N\}$; there is a measure one of firms in each sector
- **Factors**: firms use labor and intermediate inputs purchased from other firms
- **Government Policy**: central bank sets the level of money supply M_t

Households

- The representative household maximizes expected lifetime utility:

$$\mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t \left[\log C_t - L_t\right]$$

subject to a standard budget constraint

- Households are also subject to a **cash-in-advance** constraint: $P_t^C C_t \leq M_t$

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- Aggregate consumption: $C_t = \iota^C \prod_{i=1}^N C_i^{\overline{\omega}_i^C}, \quad \sum_{i=1}^N \overline{\omega}_i^C = 1, \quad \overline{\omega}_i^C \geq 0, \forall i$

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- Sectoral consumption: $C_{i,t} = \left\{ \int_0^1 \left[\zeta_{i,t}(j) C_{i,t}(j)\right]^{\frac{\epsilon-1}{\epsilon}} dj \right\}^{\frac{\epsilon}{\epsilon-1}}, \quad \epsilon > 1$

where $\zeta_{i,t}(j)$ is a **firm-level quality** process:

$$\log \zeta_{i,t}(j) = \log \zeta_{i,t-1}(j) + \sigma_i \varepsilon_{i,t}(j)$$

Firms: production

- Any firm j in sector i has access to the following production technology:

$$Y_{i,t}(j) = \iota_i \frac{1}{\zeta_{i,t}(j)} \times A_{i,t} \times L_{i,t}(j)^{\overline{\alpha}_i} \prod_{k=1}^{N} X_{i,k,t}(j)^{\overline{\omega}_{ik}},$$

where $A_{i,t}$ is a **sectoral productivity** process, $L_{i,t}(j)$ is firm-level labor input, $X_{i,k,t}(j)$ is firm-level intermediate input demand for sector k's goods and $\quad \overline{\alpha}_i + \sum_{k=1}^{N} \overline{\omega}_{ik} = 1, \quad \overline{\alpha}_i \geq 0, \overline{\omega}_{ik} \geq 0, \ \forall i, k$

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- Cost-minimization delivers the following marginal cost:

$$MC_{i,t}(j) = \zeta_{i,t}(j) \times \frac{1}{A_{i,t}} \times W_t^{\overline{\alpha}_i} \prod_{k=1}^{N} P_{k,t}^{\overline{\omega}_{ik}}.$$

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- Let $p_{i,t}(j) \equiv \log \tilde{P}_{i,t}(j) = \log \frac{P_{i,t}(j)}{\zeta_{i,t}(j) M_t}$ be the quality-adjusted *log* real price

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- The value of a firm in sector i that has set a quality-adjusted real price p:

$$V_{i,t}(p) = \tilde{\mathcal{D}}_{i,t}(p) + \beta \mathbb{E}_t \left[\{1 - \eta_{i,t+1}(p - \sigma_i \varepsilon_{i,t+1} - m_{t+1})\} \times V_{i,t+1}(\overbrace{p - \sigma_i \varepsilon_{i,t+1} - m_{t+1}}^{\text{"Eroded" real price}}) \right]$$

$$+\beta \mathbb{E}_t \left[\underbrace{\eta_{i,t+1}(p - \sigma_i \varepsilon_{i,t+1} - m_{t+1})}_{\text{Pr. of adjustment}} \times \left(\max_{p'} V_{i,t+1}(p') - \kappa_{i,t} \right) \right]$$

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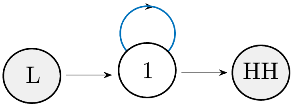
- Following Golosov and Lucas (2007), we assume the following **adjustment hazard** $\eta_{i,t}(.)$:

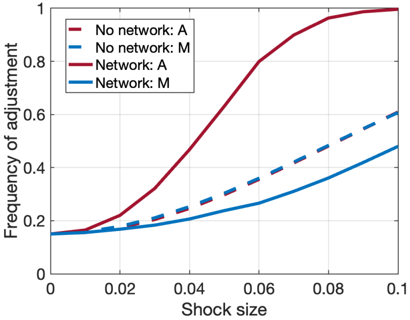
$$\eta_{i,t}(p) = \mathbf{1}(L_{i,t}(p) > 0) = \mathbf{1}\left(\max_{p'} V_{i,t}(p') - V_{i,t}(p) > \overline{\kappa}_i \right)$$

EXAMPLE ECONOMIES

Toy example 1: roundabout production

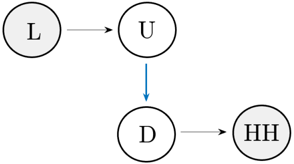
- Marginal cost: $MC(j) = \zeta(j) \times \frac{1}{A} \times M^{\overline{\alpha}} P^{1-\overline{\alpha}}$

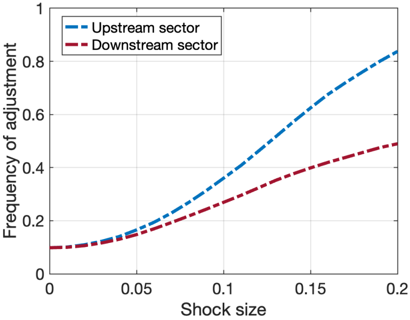




Toy example 2: two-sector vertical chain

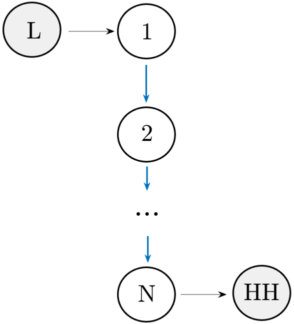
- Marginal costs: $MC_U(j) = \zeta_U(j) \times \frac{1}{A_U} \times M, \quad MC_D(j) = \zeta_D(j) \times \frac{1}{A_D} \times P_U$

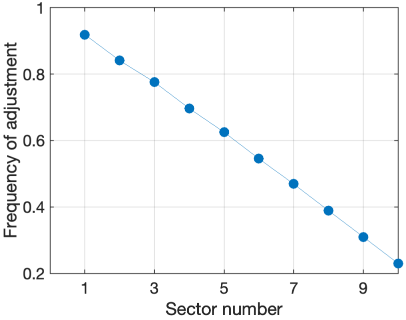




Toy example 3: *N*-sector vertical chain

- Marginal costs: $MC_i(j) = \zeta_i(j) \times \frac{1}{A_i} \times P_{i-1}$





QUANTITATIVE RESULTS

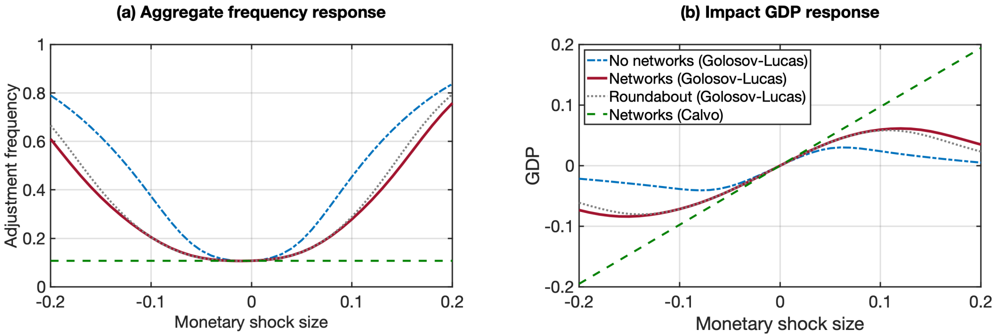
Calibration (Euro Area, monthly frequency)

		Aggregate parameters	
$\overline{\pi}$	0.02/12	Trend inflation (monthly)	ECB target
ρ	0.90	Persistence of the TFP shock	Half-life of seven months
		Sectoral parameters	
N	39	Number of sectors	ECB PRISMA data coverage
$\{\overline{\omega}_i^C\}_{i=1}^N$		Sector consumption weights	World IO Tables
$\{\overline{\omega}_{ik}\}_{i,k=1}^N$		Sector input-output matrix	World IO Tables
$\{\overline{\alpha}_i\}_{i=1}^N$		Sector labour weights	World IO Tables
		Firm-level pricing parameters	
$\{\overline{\kappa}_i\}_{i=1}^N$		Menu costs	Estimated to fit frequency, std dev.
$\{\sigma_i\}_{i=1}^N$		Std. dev. of firm-level shocks	of Δp from ECB PRISMA

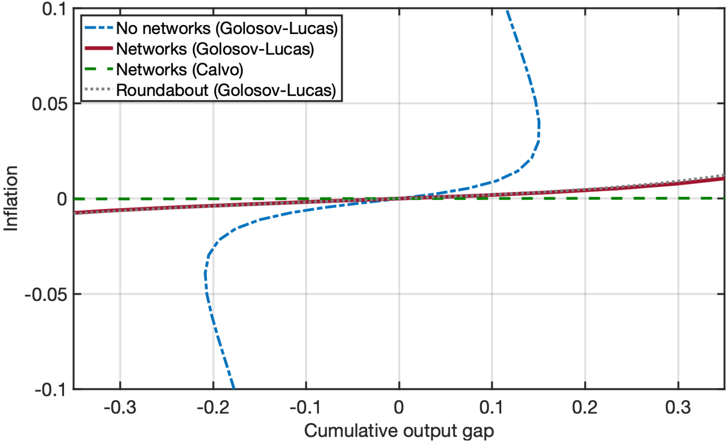
Monetary shocks

$$\log M_t = \overline{\pi} + \log M_{t-1} + \varepsilon_t^M$$

Cascades dampening following monetary shocks



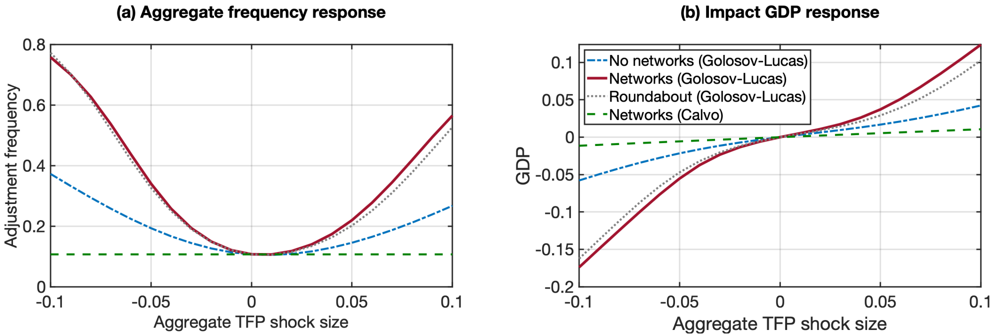
Non-linear **Phillips Curves**



Aggregate TFP shocks

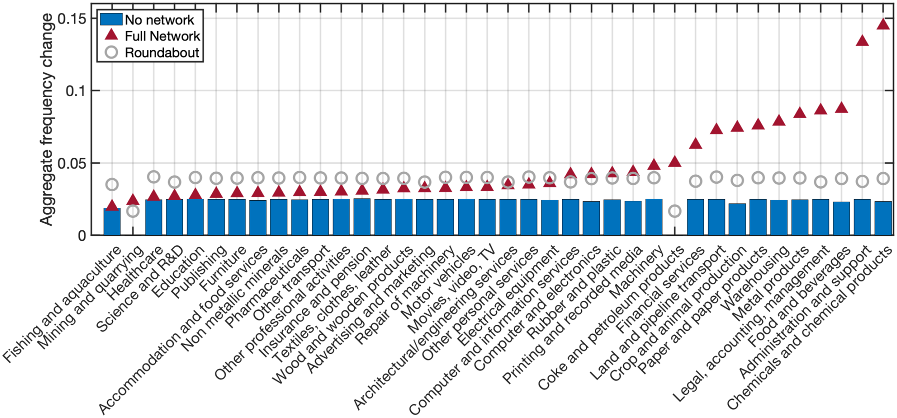
$$\log A_t = \rho \log A_{t-1} + \varepsilon_t^A$$

Cascades amplification following TFP shocks



Sectoral TFP shocks

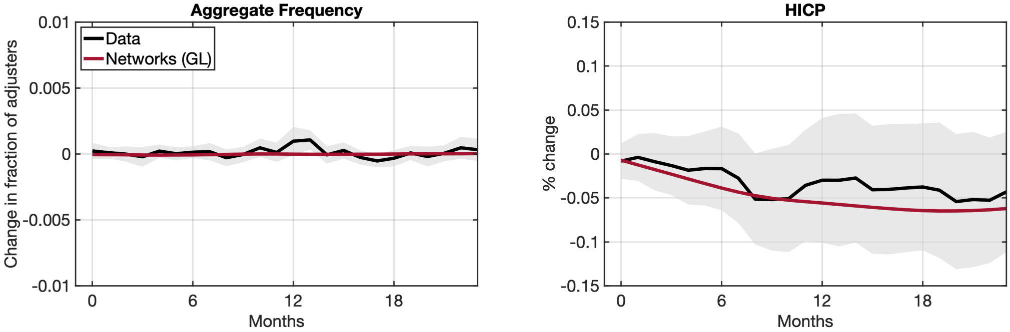
Aggregate frequency responses to sectoral TFP shocks (-50%)



EMPIRICAL VALIDATION

Small shocks

Small shocks analysis: monetary shock (Jarociński and Karadi, 2020)



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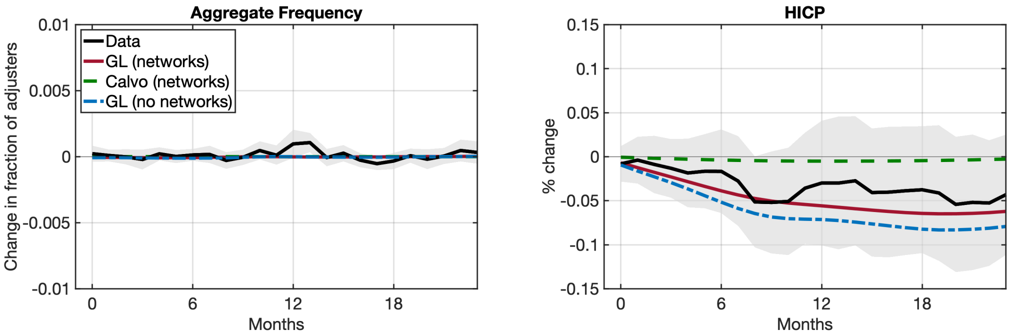
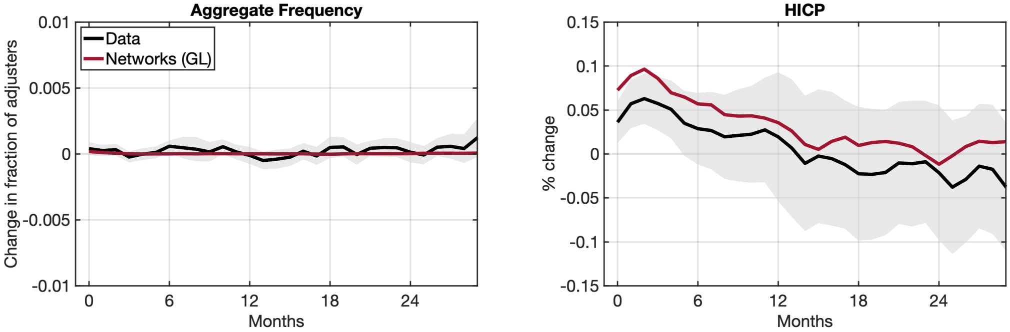


Small shocks analysis: oil shock (Känzig, 2021)



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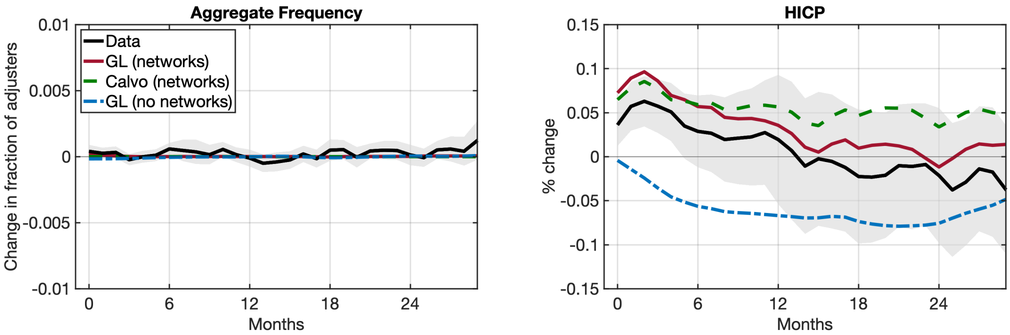
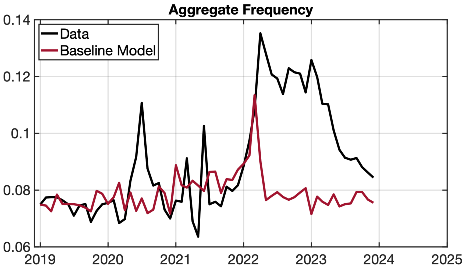


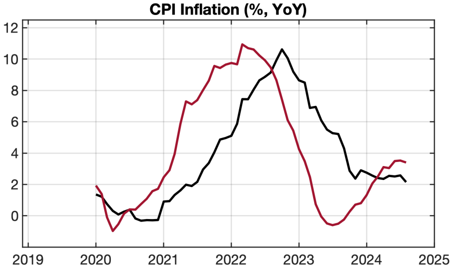
(Post-)Covid inflation in the Euro Area

Model vs. Data

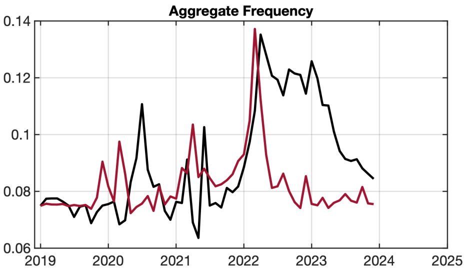
- To assess the model quantitatively, we feed in observed demand and supply processes as exogenous shocks
- **Aggregate demand shock**: Euro Area nominal GDP as a proxy for the $\{M_t\}_{t\geq 0}$ process
- **Energy price shock**: calibrate the productivity process of the "Mining and Quarrying" sector to match the IMF Global Price of Energy Index movements
- **Food price shock**: calibrate the productivity process of the "Crop and Animal Production" sector to match the IMF Global Price of Food Index movements
- **Labor market shock**: calibrate the productivity process of the labor union sector to match the hourly earnings dynamics in the Euro Area

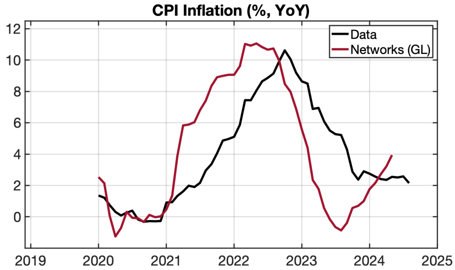
Model vs. Data: baseline setup, all shocks (perfect foresight)



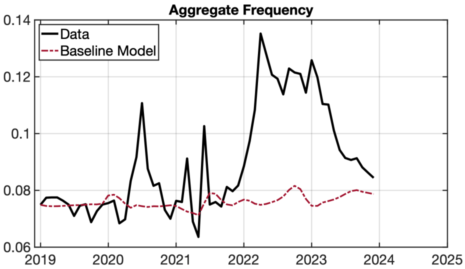


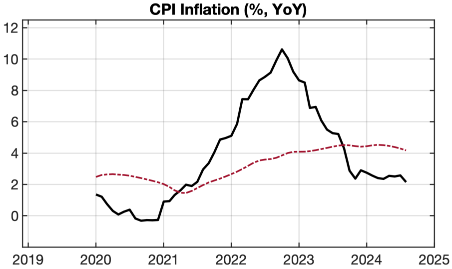
Model vs. Data: baseline setup, all shocks (unanticipated shocks)



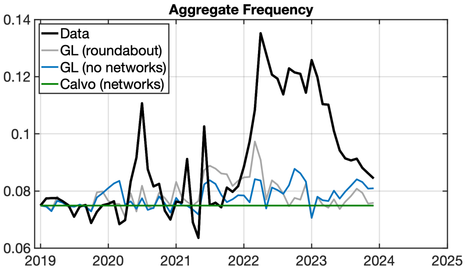


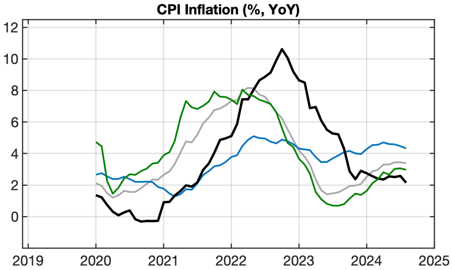
Model vs. Data: baseline setup, no commodity shocks





Model vs. Data: alternative setups, all shocks





Conclusions

- Present a **dynamic quantitative** general equilibrium model that features: a number of **sectors interconnected by networks** with **state-dependent pricing** that is solved **fully non-linearly**
- Networks **slow down** the extensive margin pricing response to **demand shocks**: **cascades dampening**
- Networks **speed up** the extensive margin response to **supply shocks**: **cascades amplification**
- **Interaction** of networks and pricing cascades crucial for **quantitatively** matching the observed surges in inflation and repricing frequency in the Euro Area

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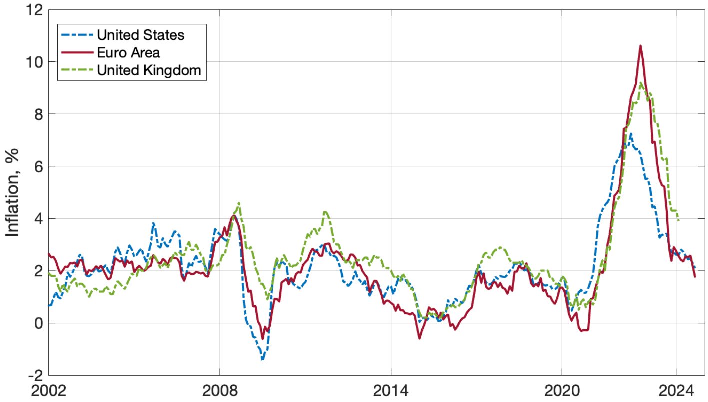
APPENDIX

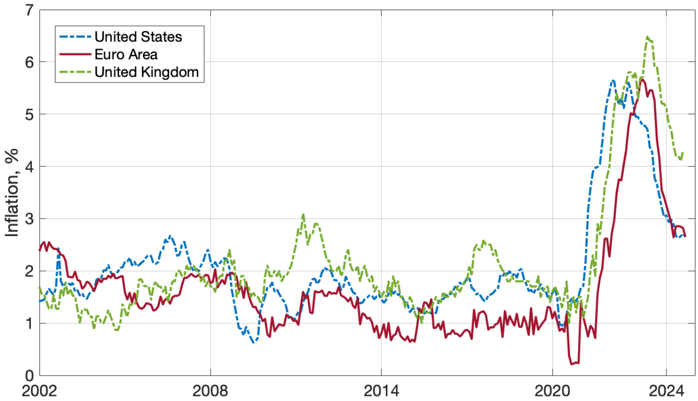
Evidence I: inflation spikes in advanced economies (headline)



Source: FRED.

▸ Back

Evidence I: inflation spikes in advanced economies (core)



Source: FRED.

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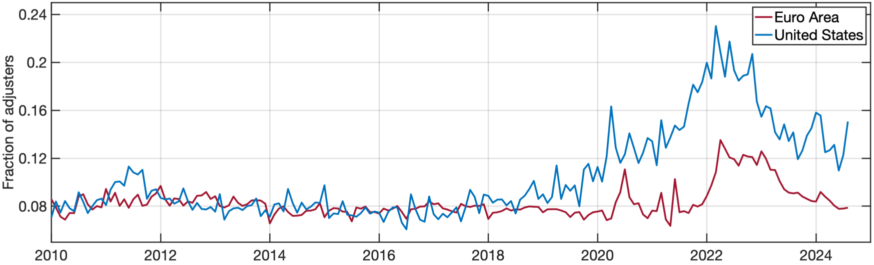
Evidence II: changes in frequency of price adjustment



Source: Montag and Villar (2024), Dedola et al. (2024).

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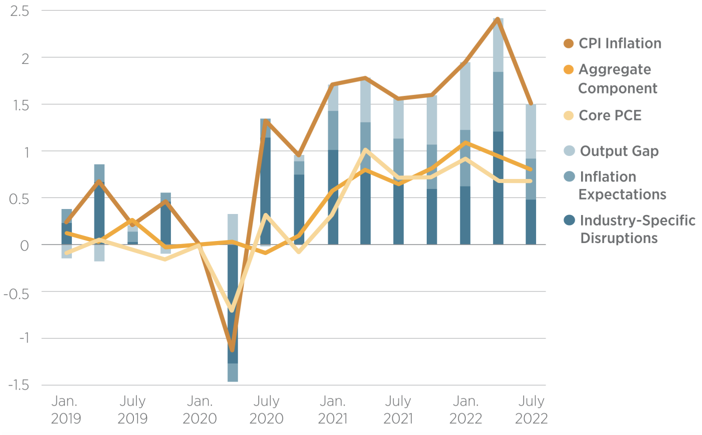
Evidence III: sectoral origins of inflation



Source: Rubbo (2024).

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Cascades dampening under monetary shocks

Proposition

Let ϱ_i be the probability that a firm in sector i decides to adjust its price. Following a monetary shock m, denote by $\Delta\varrho_i(m)$ the change relative to steady-state, then:

$$\frac{1}{\chi_i}\Delta\varrho_i(m) \quad \approx \quad \left[\quad m \quad + \quad \overline{\mu} \times \mathcal{C}_i \quad + \quad N \times Cov\left((\overline{\Psi} - I)^{(i)}, \boldsymbol{\mu}\right) \quad \right]^2$$

where $\chi_i \equiv -\Xi_i''\left(\sqrt{\frac{2\overline{\kappa}_i}{\epsilon-1}}\right) > 0$ *and* Ξ_i *is CDF of* $\mathcal{N}(0,\sigma_i^2)$, $\mathcal{M}_i$ *is the sectoral markup and* $\overline{\mu} \equiv \frac{1}{N}\sum_{i=1}^{N} \log \mathcal{M}_i$, $\boldsymbol{\mu} \equiv [\log \mathcal{M}_1, ..., \log \mathcal{M}_N]^T$, $\overline{\Psi} \equiv (I - \overline{\Omega})^{-1}$ *is the Leontief inverse matrix, and*

$$\mathcal{C}_i \quad \equiv \quad \sum_{j=1}^{N} \overline{\Psi}_{i,j} - 1$$

is the ***customer centrality*** *of sector i.*

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Cascades amplification under aggregate TFP shocks

Proposition

Let ϱ_i be the probability that a firm in sector i decides to adjust its price. Following a combination of sectoral productivity shocks $\mathbf{a} \equiv \{a_j\}_{j=1}^{N}$, denote by $\Delta\varrho_i(\mathbf{a})$ the change relative to steady-state, then:

$$\frac{1}{\chi_i}\Delta\varrho_i(\mathbf{a}) \quad \approx \quad \left[\sum_{j=1}^{N}\overline{\Psi}_{ij}a_j \quad - \quad \overline{\mu}\times\mathcal{C}_i \quad - \quad N\times Cov\left((\overline{\Psi}-I)^{(i)},\boldsymbol{\mu}\right)\right]^2$$

where $\chi_i \equiv -\Xi_i''\left(\sqrt{\frac{2\kappa_i}{\epsilon-1}}\right) > 0$ *and* Ξ_i *is CDF of* $\mathcal{N}(0,\sigma_i^2)$, $\mathcal{M}_i$ *is the sectoral markup and* $\overline{\mu} \equiv \frac{1}{N}\sum_{i=1}^{N}\log\mathcal{M}_i$, $\boldsymbol{\mu} \equiv [\log\mathcal{M}_1, ..., \log\mathcal{M}_N]^T$, $\overline{\Psi} \equiv (I-\overline{\Omega})^{-1}$ *is the Leontief inverse matrix, and* $\mathcal{C}_i$ *is the customer centrality measure.*

A notable special case is that of an aggregate TFP shock $a_j = a, \forall j$:

$$\frac{1}{\chi_i}\Delta\varrho_i(a) \quad \approx \quad \left[a \quad + \quad (a-\overline{\mu})\times\mathcal{C}_i \quad - \quad N\times Cov\left((\overline{\Psi}-I)^{(i)},\boldsymbol{\mu}\right)\right]^2.$$

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Cascades amplification under sectoral TFP shocks

Proposition

Set $\overline{\kappa}_i = \overline{\kappa}, \sigma_i = \sigma, \forall i$ *and assume* $Cov(\overline{\Psi}_{(i)}, \boldsymbol{\mathcal{C}}) = 0, \forall i$. *Let* $\varrho \equiv \frac{1}{N}\sum_{i=1}^{N}\varrho_i$ *be the average probability of adjustment. Following a TFP shock specific to sector k,* a_k*, denote by* $\Delta\varrho(a_k)$ *the change in the average adjustment probability relative to its steady-state value and assume that* $Cov\left((\overline{\Psi} - I)^{(i)}, \boldsymbol{\mu}\right) = 0, \forall i$*, then:*

$$\frac{1}{\chi}\Delta\varrho(a_k) \quad \approx \quad \mathcal{H}_k \times a_k^2 \quad - \quad 2\overline{\mu} \times \overline{\mathcal{C}} \times \mathcal{S}_k \times a_k \quad + \quad \overline{\mu}^2\overline{\mathcal{C}^2}$$

where $\chi \equiv -\Xi''\left(\sqrt{\frac{2\overline{\kappa}}{\epsilon - 1}}\right) > 0$ *and* Ξ *is CDF of* $\mathcal{N}(0, \sigma^2)$, $\mathcal{M}_i$ *is the sectoral markup and* $\overline{\mu} \equiv \frac{1}{N}\sum_{i=1}^{N}\log\mathcal{M}_i$, $\boldsymbol{\mu} \equiv [\log\mathcal{M}_1, ..., \log\mathcal{M}_N]^T$, $\mathcal{C}_i$ *is the customer centrality and* $\overline{\mathcal{C}} \equiv \frac{1}{N}\sum_{i=1}^{N}\mathcal{C}_i$, $\overline{\mathcal{C}^2} \equiv \frac{1}{N}\sum_{i=1}^{N}\mathcal{C}_i^2$, $\boldsymbol{\mathcal{C}} \equiv [\mathcal{C}_1, ..., \mathcal{C}_N]^T$*, and*

$$\mathcal{H}_k \equiv \frac{1}{N}\sum_{i=1}^{N}\overline{\Psi}_{i,k}^2, \qquad \mathcal{S}_k \equiv \frac{1}{N}\sum_{i=1}^{N}\overline{\Psi}_{i,k}$$

are, respectively, the ***supplier Herfindahl*** $(\mathcal{H}_k)$ *and* ***supplier centrality*** $(\mathcal{S}_k)$ *of sector k.*

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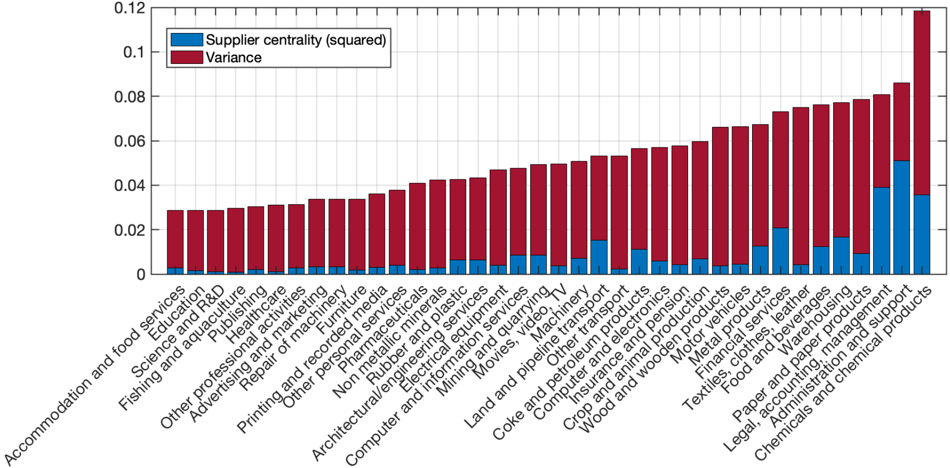
Supplier Herfindahl: a decomposition



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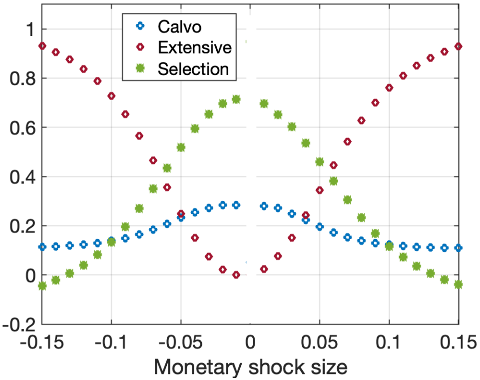
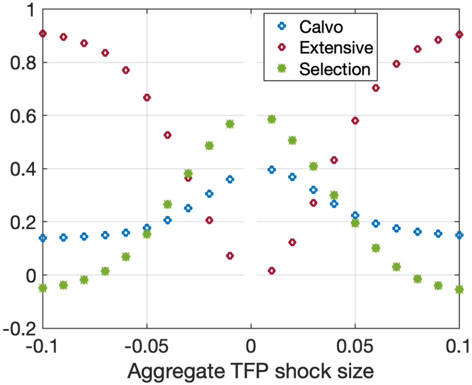
Inflation decomposition and network effects

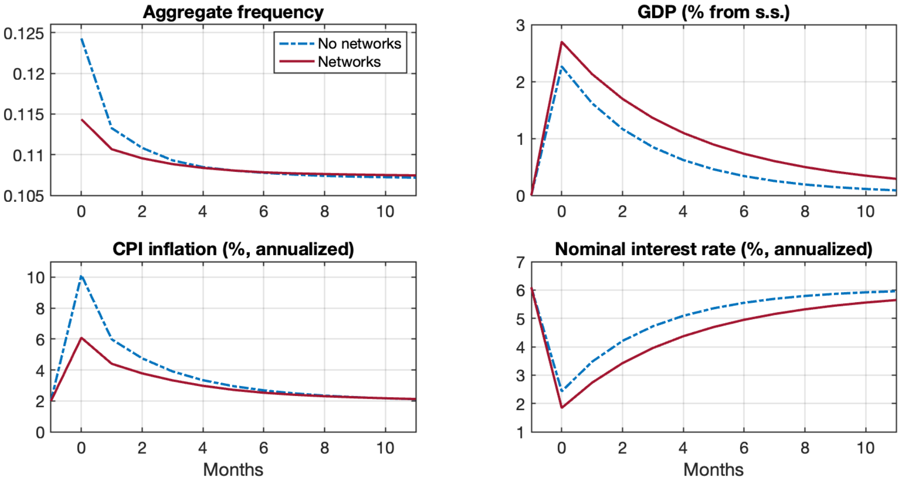
- Make use of the following inflation decomposition:

$$\Delta\pi \quad = \quad \Delta\pi^{\text{Calvo}} \quad + \quad \Delta\pi^{\text{Extensive}} \quad + \quad \Delta\pi^{\text{Selection}}$$

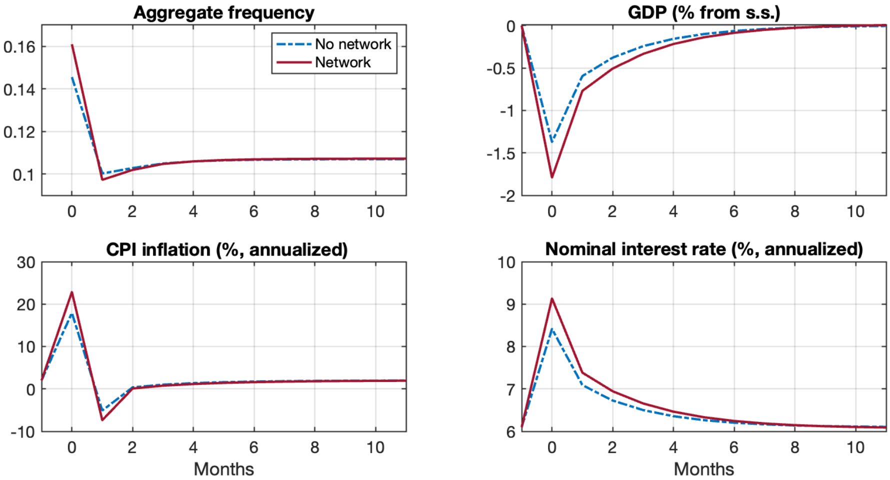




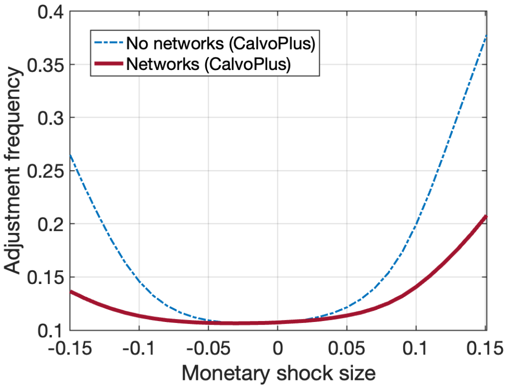
Cascades dampening following monetary shocks: Taylor rule

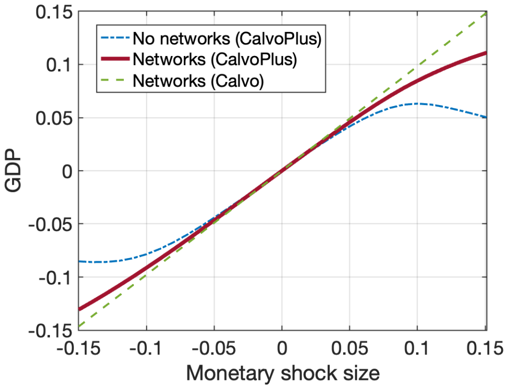


Cascades amplification following TFP shocks: Taylor rule

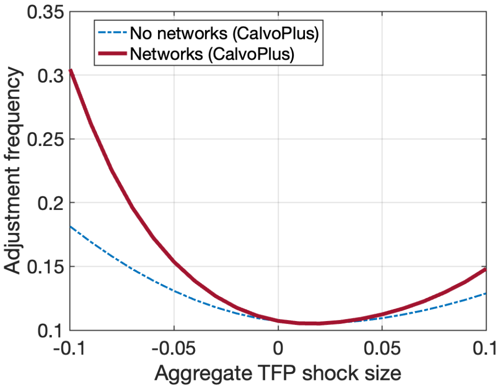


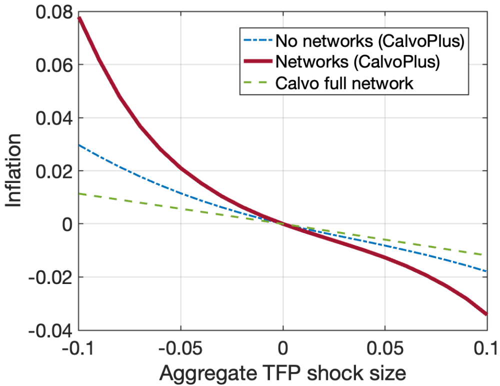
Cascades dampening following monetary shocks: CalvoPlus



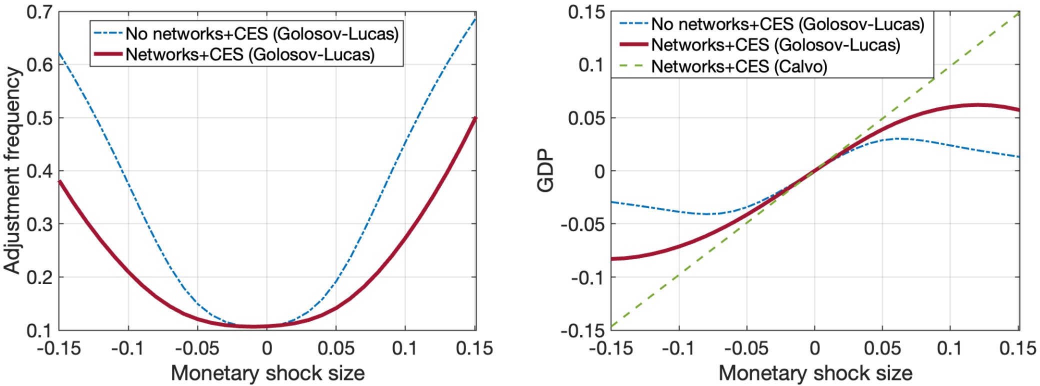


Cascades amplification following TFP shocks: CalvoPlus

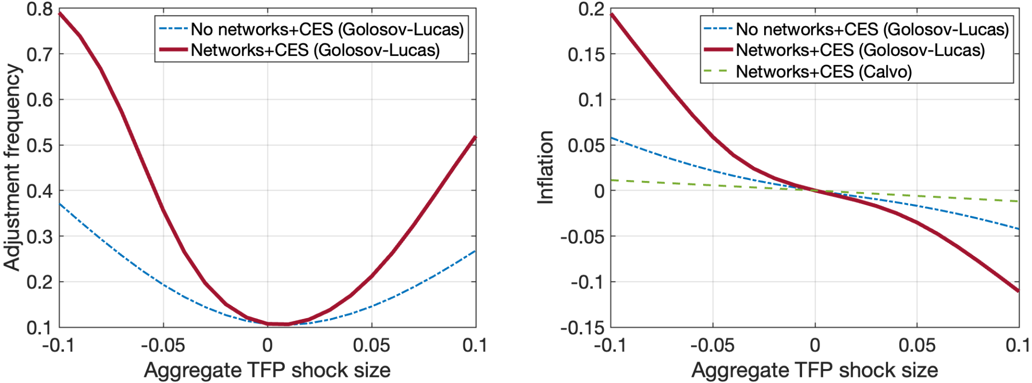




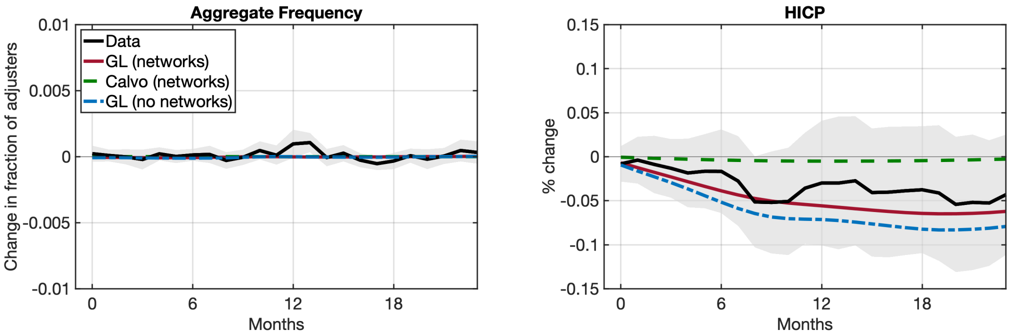
Cascades dampening following monetary shocks: CES aggregation



Cascades amplification following TFP shocks: CES aggregation



Small shocks analysis: monetary shock



Small shocks analysis: oil shock