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To my wife Esperanza and to my parents.

# Contents

LIST OF FIGURES . . . . .	v
LIST OF TABLES . . . . .	vii
ACKNOWLEDGMENTS . . . . .	viii
ABSTRACT . . . . .	ix
1 THE IMPORTANCE OF PRODUCTION NETWORKS AND SECTORAL HET- EROGENEITY FOR MONETARY POLICY . . . . .	1
1.1 Introduction . . . . .	1
1.2 Related literature . . . . .	5
1.3 Setting . . . . .	7
1.4 Equilibrium . . . . .	14
1.5 Calibration . . . . .	20
1.6 Inflation Dynamics . . . . .	24
1.7 Trend inflation, welfare, and monetary policy . . . . .	31
1.8 Conclusions . . . . .	38
1.9 Figures and Tables . . . . .	40
1.A Appendix to Section 1.3 . . . . .	58
1.B Appendix to section 1.4 . . . . .	62
1.C Appendix to Section 1.6 . . . . .	67
2 A NEW KEYNESIAN PERSPECTIVE ON TOTAL FACTOR PRODUCTIVITY VIA PRODUCTION NETWORKS . . . . .	71
2.1 Introduction . . . . .	71
2.2 A New Keynesian Model with Production Networks . . . . .	75
2.3 Stairway to Total Factor Productivity . . . . .	85
2.4 Static and Dynamic Determinants of TFP . . . . .	88
2.5 Conclusions . . . . .	94
2.6 Figures and Tables . . . . .	95
2.A Sensitivity Analysis . . . . .	102
REFERENCES . . . . .	110

## List of Figures

1.1	Steady State Within-Sector Price Dispersion . . . . .	40
1.2	Calibrated Production Network . . . . .	42
1.3	Sensitivity of Inflation to the output gap . . . . .	44
1.4	Sectoral Price Gap Coefficients, $\Phi_i^p$ . . . . .	44
1.5	Within-Sector Price Dispersion Gap Coefficients, $\Phi_i^s$ . . . . .	45
1.6	Productivity Shock Coefficients, $\Phi_i^z$ . . . . .	45
1.7	Impulse Response Functions to a 1% Monetary Shock . . . . .	49
1.8	Impulse Response Functions to a 1% Monetary Shock, All Cases . . . . .	49
1.9	Inflation Autocorrelation . . . . .	51
1.10	Consumption Equivalent . . . . .	51
1.11	Steady State Values . . . . .	53
1.12	Steady State TFP . . . . .	53
1.13	Feasible $(\sigma_C, \sigma_L)$ Frontiers . . . . .	55
1.14	Feasible $(\sigma_C, \sigma_\pi)$ Frontiers . . . . .	55
1.15	Feasible $(\sigma_C, \sigma_\pi)$ Frontiers . . . . .	56
1.16	Alternative Taylor Rules, Sectors Weighted by Stickiness . . . . .	56
1.17	Alternative Taylor Rules, Sectors Weighted by Stickiness and Centrality . . . . .	57
2.1	Star Network. One sector supplies intermediate goods to the whole economy. . . . .	95
2.2	Roundabout Network. Every sector supplies intermediate goods to the other sectors in equal amounts. . . . .	95
2.3	Input-Output Matrix, BEA 2002, U.S. Economy's 14 Main Sectors. . . . .	96
2.4	Percentage Deviation of Steady State TFP From Frictionless Level. . . . .	97
2.5	IRF to Monetary Policy Shock. . . . .	98
2.6	IRF to Monetary Policy Shock – Different $\theta$ . . . . .	98
2.7	IRF to Common Productivity Shock. . . . .	99
2.8	IRF to Idiosyncratic Productivity Shock. . . . .	99
2.9	IRF to Idiosyncratic Productivity Shock. $N = 50$ Sectors. . . . .	100
2.10	IRF to Common Price-Markup Shock. . . . .	100
2.11	IRF to Idiosyncratic Price-Markup Shock. . . . .	101
2.12	IRF to Idiosyncratic Price-Markup Shock. $N = 50$ Sectors. . . . .	101
2.13	IRF to Common Price-Markup Shock, Star Economy. Varying $\epsilon$ . . . . .	102
2.14	IRF to Idiosyncratic Price-Markup Shock, Star Economy. Varying $\epsilon$ . . . . .	103
2.15	IRF to Common Price-Markup Shock, Roundabout Economy. Varying $\epsilon$ . . . . .	103
2.16	IRF to Idiosyncratic Price-Markup Shock, Roundabout Economy. Varying $\epsilon$ . . . . .	104
2.17	IRF to Common Price-Markup Shock, 14 Sectors Calibrated U.S. Economy. Varying $\epsilon$ . . . . .	104
2.18	IRF to Idiosyncratic Price-Markup Shock, 14 Sectors Calibrated U.S. Economy. Varying $\epsilon$ . . . . .	105
2.19	IRF to Monetary Policy Shock. Varying Intermediate Goods Shares. . . . .	105
2.20	IRF to Common Productivity Shock. Varying Intermediate Goods Shares. . . . .	106
2.21	IRF to Idiosyncratic Productivity Shock. Varying Intermediate Goods Shares. . . . .	106
2.22	IRF to Common Price-Markup Shock. Varying Intermediate Goods Shares. . . . .	107

2.23	IRF to Idiosyncratic Price-Markup Shock. Varying Intermediate Goods Shares.	107
2.24	IRF to Common Productivity Shock. Varying Degrees of Price Stickiness. . . .	108
2.25	IRF to Idiosyncratic Productivity Shock. Varying Degrees of Price Stickiness. .	108
2.26	IRF to Common Price-Markup Shock. Varying Degrees of Price Stickiness. . . .	109
2.27	IRF to Idiosyncratic Price-Markup Shock. Varying Degrees of Price Stickiness. .	109

## List of Tables

1.1	Sectoral Productivity Shocks and Intermediate Inputs . . . . .	41
1.2	Business Cycle Parameters . . . . .	42
1.3	Five different economies . . . . .	43
1.4	Correlation Coefficients-Characteristics . . . . .	46
1.5	Sectoral NKPC Coefficients with No Trend Inflation . . . . .	47
1.6	Sectoral NKPC Coefficients with Trend Inflation of 2% . . . . .	48
1.7	Cumulative response to a 1% monetary shock, baseline calibration . . . . .	50
1.8	Consumption Equivalent . . . . .	52
1.9	Annualized Standard Deviations . . . . .	54
2.1	<b>Deep Parameters Parameterization</b> . . . . .	95
2.2	<b>Shocks' Parameters Parameterization</b> . . . . .	96

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## ABSTRACT

This thesis is separated in two chapters. In the first chapter I develop a multi-sector model with price frictions, production networks, trend inflation and different types of shocks to study how these conditions affect the properties of inflation and their implications for monetary policy. Calibrating the model to the U.S. economy my results show that in this setting inflation becomes 30% less sensitive to the output-gap compared to a standard one-sector model. Furthermore, in the multi-sector model inflation is affected by sectoral variables linked to between-sector and within-sector price distortions. This fact adds inertia to the inflationary process and makes monetary policy less effective. Additionally, the welfare costs of trend inflation increase by one order of magnitude in the multi-sector model compared to the standard one-sector model. The amplification is quantitatively explained by between-sector rather than within-sector price distortions. This suggests that one-sector models and models without heterogeneity underestimate the costs of long-run inflation and the efficacy of monetary policy to fight inflation.

The second chapter is based on a paper jointly written with Francesca Loria. We construct a New Keynesian model with production networks to study how aggregate productivity, measured as the Solow residual, depends on sectoral markups and on the production network itself. The model also allows us to study the dynamic behavior of aggregate productivity facing different types of aggregate and sectoral shocks. The introduction of price stickiness allows us to shed a light on monetary-induced short run productivity changes. We calibrate a 14-sectors economy using the I-O tables from the Bureau of Economic Analysis. For the U.S. economy, aggregate productivity is quite sensitive to average markups. A relatively small average price markup of 15% over marginal cost can reduce the steady state level of productivity by 25% relative to a perfect competition case. On the dynamic dimension, we find that a 1% contractionary monetary policy shock and a 1% positive markup shocks contract total factor productivity by 3.5% and 0.1% respectively on an annual basis. Idiosyncratic shocks can have a large impact on changes in productivity depending on the centrality of the sector in the network.

# CHAPTER 1

## THE IMPORTANCE OF PRODUCTION NETWORKS AND SECTORAL HETEROGENEITY FOR MONETARY POLICY

### 1.1 Introduction

Most models in macroeconomics ignore the complexity of the real productive structure by assuming the existence of a single firm or a single productive sector instead of an interconnected network of firms and industries.<sup>1</sup> This one-sector assumption has deeply permeated the macroeconomic analysis even under circumstances where the input-output linkages between firms or industries may have first-order consequences in aggregate variables (e.g. Acemoglu et al. 2012; Baqaee and Farhi 2017).

In this paper I depart from the one-sector assumption and study an economy with monetary frictions where industries are connected through input-output linkages, and where there exists sectoral heterogeneity across these industries. By studying the properties of this economy I find relevant implications for monetary policy. Specifically, compared to the standard one-sector model, aggregate inflation reacts 30% less to the output-gap, rendering monetary policy less effective, and the welfare cost of trend inflation increases by one order of magnitude.

To reach these conclusions I develop a multi-sector model with production networks, aggregate and idiosyncratic productivity shocks. The model features nominal frictions as in Calvo (1983) but allows for sectors to differ in their frequencies of price change. The monetary authority sets an exogenously chosen rule to determine the nominal interest rate and a target of trend inflation, i.e. the level of inflation observed in the long run. I calibrate this model for the U.S. economy and compare the results with its one-sector version.

The calibrated multi-sector model presents some key distinctions from the one-sector economy one in terms of inflation dynamics and welfare losses associated with trend inflation. First, in terms of inflation dynamics, aggregate inflation in the multi-sector economy is 30% less sensitive to the output-gap, measured as the coefficient of the New-Keynesian

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1. Henceforth I use the terms sector and industry interchangeably.

Philips curve (NKPC). Sectoral heterogeneity —in the form of sectoral differences in the frequencies of price change and/or sectoral productivity shocks— affects inflation through within-industry and between-industry price distortions. This fact also reduces the relevance of aggregate output on affecting inflation, making monetary policy less effective and giving inflation higher inertia. Furthermore, higher trend inflation increases the likelihood of finding multiple equilibria in the multi-sector model, thus dynamic responses to shocks become more difficult to predict.

Second, in terms of the welfare losses from trend inflation, the multi-sector model yields larger consumption-equivalent welfare losses than the one-sector model even at moderate levels of inflation. Given the calibration of the model, where trend inflation is 2% annually, the welfare loss in the multi-sector model is 0.34% compared to 0.03% in the one-sector economy. Trend inflation affects welfare by decreasing labor productivity and by rising the volatility of consumption and labor. Productivity losses diminish welfare by increasing the amount of labor needed to produce any given level of output. Higher volatility of consumption and labor reduce welfare when individuals are risk averse. These effects are present in both the one-sector and the multi-sector economy, but are more important in the latter.

There are three main mechanisms explaining these results. First, as discussed in the monetary literature, price frictions induce inefficient price dispersion across firms since firms cannot constantly change their desired relative price given the shocks of the economy. I call these frictions *within-sector price distortions* since in a multi-sector context with atomistic firms, each firm tries to set a target for its price relative to their own sectoral price index. These relative price inefficiencies translate into output inefficiencies and, in a one-sector model, are equivalent to a lower level of aggregate productivity (e.g. Yun, 2005). Higher inflation targets increase this measure of price distortion, compromising aggregate productivity even more (e.g. Ascari and Sbordone 2014). In the multi-sector model these forces are present at the sectoral level, creating distortions in the optimal bundle of goods.

The second mechanism explaining my results is what I call *between-sector price distortions*, which is a measure of sectoral relative price deviations with respect to their optimal level. In a world without price frictions, all firms within an industry can instantaneously adjust their prices when facing external shocks. In this context, a sectoral price index would

always reflect these optimal price changes. However, this is not the case in a setting with price frictions. These frictions add sluggishness to prices, since not all firms can adjust prices simultaneously. When industries adjust prices at different frequencies, or when they adjust at the same frequency but face idiosyncratic shocks, sectoral price indices take longer to reflect their optimal relative values.<sup>2</sup> Therefore between-sector price distortions appear.

The final mechanism explaining the results is the presence of production networks. Within-sector price distortions create inefficient allocations between the goods of firms within the same sector, and between-sector price distortions negatively affect the optimal allocation between bundles of sectoral goods. When goods are also used as intermediate inputs in other industries, these inefficiencies are transmitted through the productive process. As a result, aggregating the economy with production networks amplifies the inefficient allocations, creating higher aggregate productivity losses compared to a one-sector model.<sup>3</sup> The results of this paper can be explained in light of these three mechanisms.

**The sensitivity of inflation to the output-gap.** In the standard one-sector model, the slope of the NKPC is inversely related to the degree of strategic complementarity of price setting (Woodford, 2011). When pricing decisions are strategic complements, a firm's optimal price increases as other firms increase their own prices. When prices are sticky, strategic complementarity slows optimal price adjustments to shocks. Even if a firm has the opportunity to adjust, its optimal price remains relatively unchanged if other firms have not had the opportunity to adjust yet. As a result, strategic complementarity slows down the adjustment rate of the aggregate price index. This maps into a flatter NKPC since inflation becomes less sensitive to the shocks affecting aggregate output. Additionally, the presence of production networks and, therefore of intermediate inputs, increases the degree of strategic complementarity of price setting (Basu, 1995).

To measure the sensitivity of inflation to the output-gap in the multi-sector economy I obtain the NKPC of the model, which shows the relationship between inflation and the

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2. See Carvalho (2006), Nakamura and Steinsson (2010a) and Pasten et al. (2016b) for discussions of the effects of heterogeneity in the frequencies of price change on monetary non-neutrality.

3. In Castro Cienfuegos and Loria (2017) we study this effect by focusing on the determinants of aggregate TFP in a setting similar to the one described in this paper.

output-gap. I call this the generalized NKPC since it embeds different versions of this equation as special cases.<sup>4</sup> Under the baseline calibration of the model, the coefficient of the output-gap is 30% lower compared to the one-sector counterpart. Equally important is the fact that the generalized NKPC includes variables linked to the between-sector and within-sector price distortions. Furthermore, the dynamic behavior of these variables is backward looking, which adds inertia to the inflationary process and better fits the data. On the other hand, the aggregate relevance of a sector's price distortions depends on different sector characteristics. Both within-sector and between-sector price distortions have a higher impact on aggregate inflation when the sector has higher frequency of price changes and when the sector is an important supplier of inputs into the economy.

**Welfare losses of trend inflation.** The amplification of welfare losses due to trend inflation is also explained by the three mechanisms detailed above. In a one-sector model, higher trend inflation increases inefficient price dispersion across firms, since relative prices drift away faster from their optimal levels.<sup>5</sup> Giving the opportunity of changing its price, a firm would do so by a larger amount, increasing inefficient price dispersion and lowering productivity. This is the main cause of steady-state output losses due to trend inflation in one-sector models like the one in Ascari (2004). In a multi-sector model, trend inflation makes every sector less efficient because of this mechanism, and production networks amplify this loss.

Higher trend inflation also increases the rate at which inefficient relative prices drift away, increasing the distortions associated with changes in relative sectoral prices and leading to inefficiencies in consumption and production. My results show that the loss of efficiency due to distortions in sectoral prices is the leading quantitative cause of output losses due to trend inflation. This result is new and relevant for discussions related to optimal inflation targets since it highlights the importance of using multi-sector models to correctly measure inflation costs. In a recent paper Nakamura et al. (2018) have argued that there is no empirical

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4. The generalized NKPC embeds the NKPC of Ascari (2004), Carvalho (2006), Pasten et al. (2016b) and the standard NKPC as special cases. See Appendix 1.C for details.

5. For a formal proof of the relationship between inflation and price dispersion please refer to Woodford (2011), chapter 6.

evidence of a positive relationship between price dispersion and inflation, implying that the costs of inflation are overstated in the standard New-Keynesian (NK) model relative to the menu cost model. However, my results suggest that in a multi-sector NK model, the costs of higher inflation are linked to between-sector rather than within-sector price distortions and point to the importance of taking multi-sector models into account when assessing inflation costs.

**Outline.** Section 1.2 of this paper discusses the related literature. Section 1.3 presents the setting of the model, and Section 1.4 highlights some important features of the equilibrium with price distortions and production networks. Section 1.5 describes the calibration of the model. Section 1.6 studies the dynamic properties of aggregate inflation comparing the multi-sector model with its one-sector counterpart. Section 1.7 quantifies the welfare costs of trend inflation and discusses some implications for monetary policy. Finally, Section 1.8 concludes the paper, and Section 1.9 presents tables and figures.

## 1.2 Related literature

This paper is related to a branch of the economic literature that studies the relevance of multi-sector models for aggregate outcomes. Different papers in this literature have focused on the importance of sectoral shocks to explain aggregate fluctuations (Horvath, 1998, 2000; Acemoglu et al., 2012; Carvalho, 2014; Tahbaz-Salehi et al., 2017; Atalay, 2017; Pasten et al., 2018). Most of these papers have found, either empirically or theoretically, that idiosyncratic shocks can be largely amplified and explain fluctuations of aggregate variables in an economy with production networks. I build on this previous work by taking the production network with sectoral shocks framework into a context with monetary frictions.

It also addresses a branch of the economic literature that studies the degree of monetary non-neutrality in multi-sector models or models with different types of heterogeneity. Basu (1995) shows that the input-output structure can amplify the degree of monetary non-neutrality by increasing the strategic complementarity of price setting. Carvalho (2006) shows that the degree of strategic complementarity increases in a time-dependent model with heterogeneous frequencies of price setting, increasing monetary non-neutrality. Nakamura

and Steinsson (2010a) develop a multi-sector model with menu costs in a setting with production networks and find that input-output linkages along with differences in the frequency of price changes can amplify the degree of monetary non-neutrality by a factor of 9. Pasten et al. (2016b) study the degree of monetary non-neutrality in a multi-sector setting with price stickiness as in Calvo (1983), exploring the quantitative importance of different types of heterogeneities by calibrating the economy for 350 sectors. They find that – although input-output matrices amplify the real effects of monetary shocks – heterogeneity of these linkages plays only a minor role versus other types of heterogeneity. In particular the real effects of monetary shocks rise when the share of intermediate inputs is more important and under heterogeneity in the frequency of price changes. My paper is related to these models particularly the final one, but my model includes sectoral productivity shocks and sectoral trend inflation. Moreover, I do not focus on studying the degree of monetary non-neutrality. Instead, I focus on how heterogeneity affects aggregate inflation, and the implications in terms of monetary policy.

My paper also speaks to academic and policy discussions about the optimal inflation target. The costs of inflation through increases in price dispersion have been stressed by some authors (Yun, 2005; Ascari, 2004; Ascari and Sbordone, 2014). However in recent years researchers and policy makers have argued in favor of higher inflation targets as a precautionary measure to avoid the costs associated with the zero lower bound constraint on nominal interest rates (Dell’Ariccia et al., 2010; Ball, 2014; Blanco, 2016). In this context, a proper balance of the costs and benefits of higher inflation targets is necessary. In a recent paper Nakamura et al. (2018) argue that there is no empirical evidence of the inflation costs predicted by the standard NK model. My results suggest that in a multi-sector model with heterogeneity there are additional sources of welfare costs (between-sector distortions), different from the ones predicted in the one-sector NK model. Furthermore, these distortions are relevant in creating welfare losses even at moderate inflation levels. Although it is out of the scope of this paper this effect could also be present in multi-sector menu-costs models, which points to the necessity of adopting multi-sectors models to properly measure the costs of inflation.

## 1.3 Setting

The economy is composed by  $N$  different productive sectors denoted by  $i = 1, \dots, N$ , each one consisting of a continuum of firms indexed by  $j \in [0, 1]$ , producing a differentiated good that can be used in consumption and/or production. Within each sector firms face monopolistic competition, produce with the same production function, and face the same sectoral-specific productivity shocks. As in Calvo (1983), I assume firms can re-optimize their prices with an exogenous probability  $1 - \theta_i$ , where  $\theta_i$  is the parameter of price stickiness of sector  $i$ .

One of the main differences between this model and the standard NK one is that, besides labor, a given firm uses as inputs goods produced by firms in (possibly) every other sector of the economy.

On the consumption side, I assume the economy is represented by a single household that chooses an aggregate consumption index composed by sectoral consumption bundles. At the sectoral level, consumption bundles are constant elasticity of substitution (CES) aggregators of the goods produced by individual firms within each sector so that individual firms face downward sloping demands. The household also chooses aggregate labor and savings. The following subsections give details about the optimization problems faced by each agent in this environment.

### 1.3.1 Household

The representative household maximizes the the inter-temporal utility function

$$\mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t \left( \frac{C_t^{1-\sigma}}{1-\sigma} - \frac{L_t^{1+\varphi}}{1+\varphi} \right), \quad (1.1)$$

where  $\mathbb{E}_0$  is the expectation operator conditional on information available at time  $t = 0$ ,  $C_t$  is an aggregate consumption bundle,  $L_t$  is an aggregate labor bundle,  $\beta$  is the subjective discount factor,  $\sigma \geq 1$  is the inter-temporal elasticity of substitution, and  $\varphi \geq 0$  is the inverse of the Frisch elasticity of labor. The aggregate labor bundle is a composite of labor supplied

at the sectoral level,  $L_{i,t}$ ,

$$L_t := \left( \sum_{i=1}^N L_{i,t}^{1+\varphi} \right)^{\frac{1}{1+\varphi}} .$$

On the other hand, the aggregate consumption bundle  $C_t$  is a Cobb-Douglas aggregator of sectoral consumption bundles, i.e.

$$C_t := \prod_{i=1}^N C_{i,t}^{\alpha_i},$$

where  $\alpha_i$  is the share of sectoral consumption from sector  $i$  and  $\sum_{i=1}^N \alpha_i = 1$ . Since each sector is composed by individual firms indexed in  $[0, 1]$ , the sectoral consumption bundles  $C_{i,t}$  are themselves composite consumption goods defined by the CES aggregators:

$$C_{i,t} := \left( \int_0^1 C_{(i,j),t}^{\frac{\epsilon-1}{\epsilon}} dj \right)^{\frac{\epsilon}{\epsilon-1}},$$

where  $C_{(i,j),t}$  is the quantity of a good sold by a firm  $j$  in industry  $i$  at time  $t$ , and  $\epsilon$  is the constant elasticity of substitution assumed to be the same across industries. The budget constraint of the representative household is given by:

$$P_t C_t + Q_t B_t = B_{t-1} + L_t W_t + D_t \tag{1.2}$$

where  $P_t$  is the aggregate price index defined as the minimum cost of consuming one unit of the aggregate composite good  $C_t$ ,  $B_t$  denotes holdings of one-period discount bonds,  $Q_t$  is the nominal price of bonds, and  $W_t$  is an aggregate index of sectoral wage rates  $W_{i,t}$  defined by:

$$W_t := \left( \sum_{i=1}^N W_{i,t}^{\frac{1+\varphi}{\varphi}} \right)^{\frac{\varphi}{1+\varphi}},$$

and where  $D_t = \sum_{i=1}^N \int_0^1 D_{(i,j),t} dj$  are the aggregate dividends received from ownership of all firms in the economy.

The problem for the household is thus to choose consumption  $C_t$ , labor  $L_t$  and savings  $B_t$  to maximize the lifetime utility (1.1) subject to the aggregate budget constraint (1.2). From the optimality conditions of this problem we get:

$$\frac{L_t^\varphi}{C_t^{-\sigma}} = \frac{W_t}{P_t} \quad (1.3)$$

$$1 = \mathbb{E}_t \left[ \beta \left( \frac{C_{t+1}}{C_t} \right)^{-\sigma} \frac{I_t}{\Pi_{t+1}} \right] \quad (1.4)$$

where  $\Pi_{t+1} := \frac{P_{t+1}}{P_t}$  is the aggregate gross inflation rate between period  $t$  and  $t+1$  and  $I_t = Q_t^{-1}$  is the gross nominal interest rate.

Given a solution to the problem to the household's problem, cost minimization of the aggregate consumption bundle yields the sectoral demand function:

$$C_{i,t} = \alpha_i C_t \frac{P_t}{P_{i,t}}, \quad (1.5)$$

where the aggregate price index is defined as  $P_t := \prod_{i=1}^N \left( \frac{P_{i,t}}{\alpha_i} \right)^{\alpha_i}$ . Analogously, given a solution for sectoral consumption bundles  $C_{i,t}$ , cost minimization produces the demand for goods of individual firms  $j$  in each sector  $i$ ,

$$C_{(i,j),t} = \left( \frac{P_{(i,j),t}}{P_{i,t}} \right)^{-\epsilon} C_{i,t}, \quad (1.6)$$

where  $P_{i,t} := \left( \int_0^1 P_{(i,j),t}^{1-\epsilon} dj \right)^{\frac{1}{1-\epsilon}}$  is industry  $i$ 's sectoral price index and where  $P_{(i,j),t}$  is the price charged by an individual firm  $j$  in sector  $i$  at time  $t$ .

Finally, given aggregate labor supplied  $L_t$ , optimal allocation of sectoral labor – holding labor income constant – yields the sectoral labor supply

$$L_{i,t} = \left( \frac{W_{i,t}}{W_t} \right)^{\frac{1}{\varphi}} L_t. \quad (1.7)$$

### 1.3.2 Monetary Policy

Both the nominal interest rate and trend inflation,  $I_t$  and  $\bar{\Pi}$ , are also exogenously determined. The nominal interest rate is determined by an exogenous Taylor rule, which sets this rate depending on GDP (which in this model is equal to aggregate consumption  $C_t$ ) and aggregate inflation  $\Pi_t = \prod_{i=1}^N \Pi_{i,t}^{\alpha_i}$ ,

$$\frac{I_t}{\bar{I}} = \left( \frac{I_{t-1}}{\bar{I}} \right)^{\rho_I} \left[ \left( \frac{C_t}{\bar{C}} \right)^{\phi_c} \left( \frac{\Pi_t}{\bar{\Pi}} \right)^{\phi_\pi} \right]^{1-\rho_I} Z_t^m. \quad (1.8)$$

The variables with overbar represent values in the steady state equilibrium, and  $Z_t^m$  is a monetary shock with logarithm  $z_t^m := \log Z_t^m$  following the AR(1) process  $z_t^m = \rho_m z_{t-1}^m + \varepsilon_t^m$  and  $\varepsilon_t^m \sim N(0, \sigma_m^2)$ .

### 1.3.3 Firms

Within each sector the structure of the model is akin to a standard NK model with a few modifications implied by the type of production functions. Each individual sector  $i = 1, \dots, N$  is composed by a continuum of atomistic-ininitely-lived firms indexed by  $j \in [0, 1]$ . Given a sector  $i$ , each firm  $j$  produces with the same constant returns to scale (CRS) production function,

$$Y_{(i,j),t} = Z_{i,t}^p L_{(i,j),t}^\delta \prod_{i'=1}^N X_{(i,j),i',t}^{\omega_{i,i'}} \quad (1.9)$$

where  $z_{i,t}^p := \log \left( Z_{i,t}^p \right)$  is a sectoral productivity shock following the AR(1) process

$$z_{i,t}^p = \rho_i z_{i,t-1}^p + \varepsilon_{i,t}^p, \quad (1.10)$$

$L_{(i,j),t}$  is labor used by firm  $(i, j)$  and  $X_{(i,j),i',t}$  is a CES composite good made from products

of all firms in industry  $i'$ ,

$$X_{(i,j),i',t} := \left( \int_0^1 X_{(i,j),(i',j')}^{\frac{\epsilon-1}{\epsilon}} dj' \right)^{\frac{\epsilon}{\epsilon-1}}, \quad (1.11)$$

where the elasticity of substitution  $\epsilon$  is the same across sectors and it is assumed to be the same as in the sectoral consumption bundles. Note that the share of a sectoral bundle  $i'$  in a firm's production in sector  $i$  is given by  $\omega_{i,i'}$ , and that the CRS assumption implies  $\sum_{i'=1}^N \omega_{i,i'} = 1 - \delta$ . The  $N$ -by- $N$  matrix containing these shares gives the representation of the production network and is denoted as  $\Omega$ .

Because of the assumption of CRS production functions, Equation(1.9) implies all firms within a given sector face the same marginal cost. Thus, the firms' problem can be solved first by finding the optimal mix of inputs for a given output price and then finding the optimal price given the marginal cost of production with that input mix. This is what I do below.

## Marginal cost

Appendix (1.A.1) shows that a firm  $(i, j)$ 's cost minimization problem can be written in terms of sectoral variables. A firm  $(i, j)$ 's cost of producing a given level of output  $Y_{(i,j),t}$  is given by

$$\mathcal{C} \left( Y_{(i,j),t} \right) = \min_{L_{(i,j),t}, \{X_{(i,j),i',t}\}} W_{i,t} L_{(i,j),t} + \sum_{i'=1}^N X_{(i,j),i',t} P_{i',t}$$

subject to the production function (1.9). The price index from an industry  $i'$  is defined as  $P_{i',t} := \left( \int_0^1 P_{(i',j'),t}^{1-\epsilon} dj' \right)^{\frac{1}{1-\epsilon}}$ . Note that the assumption of same elasticity of substitution in consumption and production allows for the definition of just one sectoral price index for both production and consumption. The solution to this problem yields the following formula for

the nominal marginal cost of production in industry  $i$ ,

$$MC_{i,t} = \frac{P_{i,t}^m \left( \frac{W_{i,t}}{\delta} \right)^\delta}{Z_{i,t}^p}, \quad (1.12)$$

where  $P_{i,t}^m$  is the industry-specific price index of materials, defined by

$$P_{i,t}^m = \prod_{i'=1}^N \left( \frac{P_{i',t}}{\omega_{i,i'}} \right)^{\omega_{i,i'}}.$$

The CRS assumption allows me to write the total cost of production simply as:

$$\mathcal{C} \left( Y_{(i,j),t} \right) = MC_{i,t} Y_{(i,j),t}. \quad (1.13)$$

It is useful to produce expressions for the conditional factor demands of a particular firm. Given a level of output  $Y_{(i,j),t}$ , the nominal marginal cost and inputs prices, a firm  $(i, j)$  chooses labor and materials from industry  $i'$  such that

$$L_{(i,j),t} = \delta \frac{MC_{i,t}}{W_{i,t}} Y_{(i,j),t}, \quad (1.14)$$

$$X_{(i,j),i',t} = \omega_{i,i'} \frac{MC_{i,t}}{P_{i',t}} Y_{(i,j),t}. \quad (1.15)$$

## Price optimization

Before presenting the price optimization problem it is necessary to derive the total demand for goods produced by a firm  $(i, j)$ . A particular firm  $(i, j)$  can sell its product either as consumption good or as intermediate input to all firms from (possibly) all sectors. Thus,

the market clearing condition faced by this firm is

$$Y_{(i,j),t} = C_{(i,j),t} + \sum_{i'=1}^N \int_0^1 X_{(i',j')(i,j),t} dj'. \quad (1.16)$$

Appendix 1.A.1 shows that, by using the optimality conditions implied by the CES structure of the consumption and production aggregators, equation (1.16) becomes

$$Y_{(i,j),t} = \left( \frac{P_{(i,j),t}}{P_{i,t}} \right)^{-\epsilon} Y_{i,t}, \quad (1.17)$$

where  $Y_{i,t}$  represents total sectoral output and is defined as:

$$Y_{i,t} := C_{i,t} + \sum_{i'=1}^N X_{i',i,t}, \quad (1.18)$$

and where  $X_{i',i,t} := \int_0^1 X_{(i',j'),i,t} dj'$  is the total demand from industry  $i'$  for inputs from industry  $i$ .

The problem of the firm is then to choose the optimal price  $P_{(i,j),t}$  to maximize the expected present value of future profits,

$$\mathbb{E}_t \sum_{k=0}^{\infty} \frac{\Lambda_{t,t+k}}{P_{t+k}} \theta_i^k \left( P_{(i,j),t} - MC_{i,t+k} \right) Y_{(i,j),t+k}, \quad (1.19)$$

subject to the individual firm demand (1.17), and where  $\Lambda_{t,t+k}$  is an endogenous discount factor between periods  $t$  and  $t+k$ .

The first-order condition of this problem allows to solve for the optimal sectoral price relative to the aggregate price index,  $p_{i,t}^* := \frac{P_{i,t}^*}{P_t}$ ,

$$p_{i,t}^* = \frac{\epsilon}{\epsilon - 1} \frac{\psi_{i,t}}{\Delta_{i,t}}, \quad (1.20)$$

where  $\psi_{i,t}$  and  $\Delta_{i,t}$  are auxiliary variables representing the expected discounted value of

marginal costs and marginal revenues respectively. Appendix 1.A.1 shows that the expected discounted value of marginal costs follows the recursive relationship

$$\psi_{i,t} = Y_{i,t} C_t^{-\sigma} mc_{i,t} + \theta_i \beta \mathbb{E}_t \left[ \Pi_{i,t+1}^\epsilon \psi_{i,t+1} \right], \quad (1.21)$$

where  $\Pi_{i,t+1} := \frac{P_{i,t+1}}{P_{i,t}}$  is the sectoral gross inflation rate, and  $mc_{i,t} := MC_{i,t}/P_t$  is the real marginal cost in this industry.

Appendix 1.A.1 also shows that  $\Delta_{i,t}$  can be expressed in terms of other variables to simplify the equilibrium. This produces the following relationship:

$$\begin{aligned} \left( \frac{1 - \theta_i \Pi_{i,t}^{\epsilon-1}}{1 - \theta_i} \right)^{\frac{1}{\epsilon-1}} \psi_{i,t} &= \frac{\epsilon - 1}{\epsilon} Y_{i,t} C_t^{-\sigma} p_{i,t} \\ &+ \theta_i \beta \mathbb{E}_t \left[ \Pi_{i,t+1}^{\epsilon-1} \left( \frac{1 - \theta_i \Pi_{i,t+1}^{\epsilon-1}}{1 - \theta_i} \right)^{\frac{1}{\epsilon-1}} \psi_{i,t+1} \right]. \end{aligned} \quad (1.22)$$

Equations (1.21) and (1.22) are valid for every industry  $i$  and are required to solve the equilibrium system.

## 1.4 Equilibrium

In this section I describe the model's equilibrium system and some of its properties related to within-sector and between-sector price dispersion. The system of equations describing the equilibrium is composed by the optimality conditions of the household and the firms described in the previous section along with the market clearing conditions. The resulting system is then log-linearized around a steady state with trend inflation  $\bar{\Pi}$ . I start this section by describing the market clearing conditions and how these conditions are affected by within-sector price dispersion and the production network.

### 1.4.1 Market clearing

First, let us define the measure of within-sector price dispersion as  $s_{i,t} := \int_0^1 \left( \frac{P_{i,t}(i,j)}{P_{i,t}} \right)^{-\epsilon} dj$ . Appendix 1.B shows that  $s_{i,t}$  follows a backward looking law of motion depending on sectoral inflation and the degree of price stickiness,

$$s_{i,t} = (1 - \theta_i) \left( \frac{1 - \theta_i \Pi_{i,t}^{\epsilon-1}}{1 - \theta_i} \right)^{\frac{\epsilon}{\epsilon-1}} + \theta_i \Pi_{i,t}^{\epsilon} s_{i,t-1}. \quad (1.23)$$

In a one-sector model this measure is simply referred to as “price dispersion” and is not relevant up to first-order approximations of the equilibrium around a zero-inflation steady state. Since firms are homogeneous and they would all charge the same price without price frictions, this measure of price dispersion also represents a measure of price distortions. In a multi-sector model with heterogeneity, each sector has their own measure of price dispersion depending on sectoral price stickiness  $\theta_i$  and the sectoral gross inflation rate  $\Pi_{i,t}$ . Most importantly, within-sector price dispersion creates inefficiencies, and in a multi-sector model these inefficiencies are transmitted to other sectors through the production network.

**Within-sector price distortion inefficiencies.** The type of inefficiencies caused by within-sector price distortion becomes clearer when obtaining the different market-clearing conditions of the model. Using the input demands of the firm (1.14) and (1.15) plus the output demand yields the following sectoral input demands:

$$L_{i,t} := \int_0^1 L_{(i,j),t} dj \Rightarrow L_{i,t} = \delta \frac{mc_{i,t}}{w_{i,t}} s_{i,t} Y_{i,t} \quad (1.24)$$

$$X_{i,i',t} := \int_0^1 X_{(i,j),i',t} dj \Rightarrow X_{i,i',t} = \omega_{i,i'} \frac{mc_{i,t}}{p_{i',t}} s_{i,t} Y_{i,t} \quad (1.25)$$

where  $w_{i,t} := W_{i,t}/P_{i,t}$  represents the real sectoral wage.

These sectoral input demands give a partial preview of within-sector price dispersion costs; keeping everything else constant, higher price dispersion increases the quantities of

inputs needed for the same quantity of output.

This is a partial analysis, however, because within-sector price dispersion also affects the real marginal cost of each sector. To visualize this issue, we can use the marginal rate of substitution (1.3) and condition (1.7) to write the sectoral labor supply in terms of the real sectoral wage,  $\frac{L_{i,t}^\varphi}{C_t^{1-\sigma}} = w_{i,t}$ . Setting labor supply equal to labor demand in sector  $i$  yields the condition:

$$\frac{w_{i,t}}{\delta} = \left[ \frac{p_{i,t}^m s_{i,t} Y_{i,t}}{\delta^{\frac{1}{\varphi}} Z_{i,t}^p} \right]^{\frac{\varphi}{1+(1-\delta)\varphi}} C_t^{\frac{\sigma}{1+(1-\delta)\varphi}},$$

which can be replaced in the marginal cost eliminate the sectoral wage,

$$mc_{i,t} = \left( \frac{p_{i,t}^m}{Z_{i,t}^p} \right)^{\frac{1+\varphi}{1+(1-\delta)\varphi}} \left( \frac{s_{i,t} Y_{i,t}}{\delta^{\frac{1}{\varphi}}} \right)^{\frac{\delta\varphi}{1+(1-\delta)\varphi}} C_t^{\frac{\delta\sigma}{1+(1-\delta)\varphi}}. \quad (1.26)$$

Again, a partial analysis shows that higher values of  $s_{i,t}$  increase the real marginal cost of production, making sectors less efficient.

These sectoral inefficiencies negatively affect other industries through the production network channel. To see this, we can use the sectoral input demands (1.25), the sectoral consumption condition  $C_{i,t} = \alpha_i \frac{C_t}{p_{i,t}}$  and the market-clearing condition (1.18) to get

$$Y_{i,t} = \alpha_i \frac{C_t}{p_{i,t}} + \sum_{i'=1}^N \omega_{i',i} \frac{mc_{i',t}}{p_{i,t}} s_{i',t} Y_{i',t}. \quad (1.27)$$

The first term of the right-hand side in Equation (1.27) corresponds to sectoral consumption demand, while the second term represents the total demand for inputs from industry  $i$ . Evaluating the latter equation for every sector  $i$  defines a system that determines the set of gross sectoral production  $\{Y_{i,t}\}_{i=1}^N$  as a function of the other endogenous variables  $C_t, \{p_{i,t}, s_{i,t}\}_{i=1}^N$  and the exogenous shocks,  $\{Z_{i,t}^p\}_{i=1}^N$ . Price dispersion in other sectors is transmitted through the need of intermediate inputs given by the shares  $\omega_{i,i'}$ .

### 1.4.2 Model solution and relative price gaps.

The system determining the solution for the model consists of two aggregate equations and  $5N$  sectoral equations to determine  $5N + 2$  variables: value-added output  $C_t$ , the nominal interest rate  $I_t$ , and the sectoral variables  $\{\Pi_{i,t}, s_{i,t}, \psi_{i,t}, Y_{i,t}, p_{i,t}\}$ . The two aggregate equations are the Euler equation of the household (1.4) plus the Taylor rule (1.8). The sectoral equations are given by the optimal pricing equations (1.21) and (1.22), the law of motion of within-sector price distortion (1.23), the market clearing condition (1.27) where real marginal costs can be replaced using (1.26), and the following identity determining the evolution of sectoral relative prices,

$$p_{i,t} = \frac{\Pi_{i,t}}{\Pi_t} p_{i,t-1}. \quad (1.28)$$

The log-linearized system of equations is reported in Appendix 1.B.2. In this type of steady state, every sector's nominal price keeps growing at a (potentially different) gross inflation rate  $\bar{\Pi}_i$ , which generates an aggregate gross inflation rate  $\bar{\Pi} = \prod_{i=1}^N \bar{\Pi}_i^{\alpha_i}$ . An important feature of the log-linearized system is the presence of relative price gaps, that is the log-difference between the relative price of a sector and its steady state level  $\hat{p}_{i,t} := \log\left(\frac{P_{i,t}}{P_t}\right) - \log\left(\frac{P_i}{P}\right)$ . The effects of these distortions are analyzed in Section 1.6.

The next section studies some of the properties of the steady state equilibrium.

### 1.4.3 Steady state equilibrium

Although the solution of a positive inflation steady state is not available without resorting to numerical methods, in this section I briefly highlight some key features of such a steady state.

**Steady state distortions of nominal frictions.** The main difference between a zero-inflation steady state and one with positive long-run inflation is the importance of within-sector price dispersion. When inflation is zero in the long run, price dispersion becomes irrelevant in a first-order approximation because the model is approximated exactly at the point where price dispersion become minimal. On the other hand, when long-run inflation

is positive, price dispersion becomes non-negligible in a first-order approximation.

Evaluating equation (1.59) in steady state yields the long run level of price dispersion:

$$\bar{s}_i = \frac{1 - \theta_i}{1 - \theta_i \bar{\Pi}_i^\epsilon} \left( \frac{1 - \theta_i \bar{\Pi}_i^{\epsilon-1}}{1 - \theta_i} \right)^{\frac{\epsilon}{\epsilon-1}}. \quad (1.29)$$

Sectoral steady-state price dispersion is increasing with the degree of price stickiness  $\theta_i$ , the elasticity of substitution  $\epsilon$ , and sectoral trend inflation  $\bar{\Pi}_i$ . Note that without trend inflation, the gross inflation rate is  $\bar{\Pi}_i = 1$  and  $\bar{s}_i$  attains its minimum at  $\bar{s}_i = 1$ , which is illustrated in Figure 1.2a. Furthermore, the price dispersion measure is not well defined when  $\left(\frac{1}{\theta_i}\right)^\frac{1}{\epsilon} < \bar{\Pi}_i$  since this would result in negative values. As a result the existence of an equilibrium is restricted by this condition, which must be satisfied in every sector. Figure 1.2b illustrates this fact. The figure shows that given the elasticity of substitution  $\epsilon$ , higher degrees of price stickiness  $\theta_i$  restrict the possible values of trend inflation over which  $\bar{s}_i$  is well defined. This condition makes models with heterogeneous price stickiness less stable, something that is discussed later.

Another interesting feature comes from evaluating the real marginal cost in steady state,

$$\bar{m}c_i = (\bar{p}_i^m)^{\frac{1+\varphi}{1+(1-\delta)\varphi}} \left( \frac{\bar{s}_i \bar{Y}_i}{\delta^{\frac{1}{\varphi}}} \right)^{\frac{\delta\varphi}{1+(1-\delta)\varphi}} \frac{\delta\sigma}{C^{1+(1-\delta)\varphi}}. \quad (1.30)$$

This expression shows that given a particular value for the other variables, higher price dispersion in a particular sector increases the marginal cost of production in that sector. Note without trend inflation  $\bar{\Pi}_i = 1$  and thus  $\bar{s}_i = 1$  so that the marginal cost is not affected. This result has been studied before by other authors (e.g. Ascari and Sbordone, 2014), who show the link between higher price dispersion and lower steady state consumption. What is new here is the fact that – due to the existence of production networks – price dispersion in sector  $i$  not only affects this sector's marginal cost of production, but also increases the cost of all other sectors using sector  $i$ 's goods as inputs for their own productive process.

This is explored below by mapping the multi-sector model into a one-sector economy with an aggregate production function.

## Aggregate Production Function

To illustrate the effects of long-run inflation, sectoral heterogeneity, and production networks in this subsection I show that the  $N$ -sector model with constant returns to scale is isomorphic with a one-sector economy with a production function linear in aggregate labor. Total factor productivity of this production function (measured as the Solow residual) is an endogenous object depending upon, among other things, sectoral trend inflation and the structure of the production network. The procedure to generate this aggregate production function is similar to the one in Jones (2011) with the difference of including monetary frictions and monopolistic competition of firms.

Before showing the aggregate production function I need to define some endogenous objects of the model. Let

$$\eta_{i,t} := \frac{Y_{i,t}p_{i,t}}{C_t} \tag{1.31}$$

denote the Domar weight of sector  $i$ , that is the ratio of the value of sectoral production  $i$  relative to aggregate GDP. Appendix 1.B.3 shows how to determine the Domar weights given the endogenous variables of the model. Next, let

$$\kappa_{i,t} := L_{i,t}/L_t \tag{1.32}$$

denote the share of sectoral labor  $L_{i,t}$  relative to the aggregate labor index. Appendix 1.B.3 shows that in equilibrium this share is a function of the Domar weights and other endogenous variables of the model. With this information I can now state Proposition 1.

**Proposition 1.** *Under the assumptions of the model presented in Section 1.3.1, Section 1.3.3 and Section 1.4, and given the definitions (1.31) and (1.32), the multi-sector economy with production networks and nominal frictions is isomorphic with a one-sector economy*

with an aggregate production function linear in aggregate labor. In steady state the aggregate production function satisfies

$$\bar{C} = \overline{TFP} \cdot \bar{L} \quad (1.33)$$

where

$$\overline{TFP} = \exp \left\{ \boldsymbol{\alpha}' \left[ \bar{\boldsymbol{\alpha}} + (\mathbf{I} - \boldsymbol{\Omega})^{-1} \bar{\mathbf{a}} \right] \right\} \quad (1.34)$$

where  $\bar{\boldsymbol{\alpha}}$  and  $\bar{\mathbf{a}}$  are  $N$ -by-1 vectors with typical element defined by

$$\bar{a}_i := \delta \log(\bar{\kappa}_i) + \sum_{i'=1}^N \omega_{i,i'} \log \left( \omega_{i,i'} \frac{\bar{m}c_i \bar{s}_i \bar{\eta}_i}{\bar{p}_i \bar{\eta}_{i'}} \right) \quad (1.35)$$

$$\bar{\alpha}_i := \log \left( \frac{\alpha_i}{\eta_i} \right). \quad (1.36)$$

For a proof of Proposition 1 please refer to Section 1.B.3 of the Appendix.

I close this section noting that Proposition 1 together with the steady state conditions (1.29) and (1.30) shows that trend inflation and heterogeneity of price stickiness affect  $\overline{TFP}$  directly through marginal costs  $\bar{m}c_i$  and within-sector price dispersion  $\bar{s}_i$ . These monetary frictions also affect  $\overline{TFP}$  indirectly through the steady state equilibrium levels of the other endogenous variables  $\bar{p}_i$ ,  $\bar{\kappa}_i$  and  $\bar{\eta}_i$ .  $\overline{TFP}$  also depends on the Leontief inverse  $(\mathbf{I} - \boldsymbol{\Omega})^{-1}$ , showing how production networks can play a role amplifying distortions. I return to this discussion in Section 1.7 to understand the quantitative effects these different elements have on  $\overline{TFP}$  and welfare.

## 1.5 Calibration

This section describes the baseline calibration of the model and the data sources. One of the objectives of the calibration is to compute the model's dynamic simulations in the presence of monetary and productivity shocks. To this end, I use the sectoral definitions of the 35-sector *KLEMS* dataset developed by Dale W. Jorgenson and described in Jorgenson et al. (2000). The dataset covers 35 sectors at roughly the 2-digit SIC level from 1960 to 2005, however

I exclude the government sector to match the model. As explained in Section 1.5.1 and below, the *KLEMS* dataset provides detailed sectoral data of gross output plus quantities and prices of inputs used in each industry’s production. This allows for the calibration of the input-output structure of the 34-sector economy and the estimation of the process of sectoral productivity. This procedure is detailed in Section 1.5.2 below. For the frequency of price changes I use the calibration from Pasten et al. (2016b), which is constructed using confidential microdata underlying the producer price index (PPI) from the BLS. These data are described in Section 1.5.3. The rest of the parameters are calibrated using standard business cycle values and are described in Section 1.5.4. The latter section also describes 5 different economies that will be studied in the rest of the paper.

### 1.5.1 Productivity shocks

For each sector, the *KLEMS* dataset contains yearly information of quantities and prices of sectoral output and inputs (capital  $K_{i,t}$ , labor  $L_{i,t}$  and materials  $M_{i,t}$ ). I calibrate the parameters of the following sectoral production function:

$$Y_{i,t} = K_{i,t}^{\delta_i^k} L_{i,t}^{\delta_i^l} M_{i,t}^{1-\delta_i} Z_{i,t}, \quad (1.37)$$

by computing time-averages of the cost shares for capital, labor, and materials. I calibrate these shares by dividing the corresponding input cost by the total cost of production. Given these shares, sectoral productivity shocks,  $Z_{i,t}$ , are computed as the residuals of Equation (1.37). The stochastic process of the detrended version of these shocks is estimated according to Equation (1.10), and a time series for the sectoral residuals  $\{\varepsilon_i^p\}_{i=1}^N$  is produced. I estimate the variance-covariance matrix  $\Sigma := \mathbb{E} \left[ \varepsilon_t^p (\varepsilon_t^p)' \right]$  using the time series of these sectoral residuals. Table 1.1 presents the estimated autoregressive coefficients for each sector, as well as the estimated standard deviation of the residuals and the calibrated share of intermediates inputs,  $1 - \delta_i$ . In the model simulations I set the share of intermediate inputs equal to the average share of intermediate inputs across sectors, which is approximately 0.45, and the share of labor equal to 0.55 to maintain *CRS* in the production functions.

### 1.5.2 Production network

The *KLEMS* dataset provides details about industry use of materials that can be used to calibrate the economy’s production network. For every industry  $i$ , the dataset contains the quantities of sectoral commodities used in production that year,  $X_{i,i'}$ , and its sectoral price index,  $P_{i'}$ . This allows me to construct cost shares for each sectoral input. On the other hand, equation (1.25) can be mapped into the data to identify the coefficients of the production network since it implies that the cost share of a sectoral input relative to the total cost of materials is:

$$\frac{X_{i,i',t}P_{i',t}}{\sum_{i'=1}^N X_{i,i',t}P_{i',t}} = \frac{\omega_{i,i'}}{(1-\delta)}. \quad (1.38)$$

Given the share of intermediate inputs  $1 - \delta$ , equation (1.38) identifies the coefficients in  $\mathbf{\Omega}$ . I calibrate these coefficients by constructing the cost shares and taking the time-average for each industry. The resulting input-output matrix is illustrated in Figure 1.2. This figure shows that the diagonal elements of the input-output matrix tend to be the most important ones, and only few sectors are important producers of inputs used by other industries. To have a measure of sector centrality in the supply chain, I define the weighted out-degree of a sector  $i$  as the share of  $i$ ’s output in the input supply of the entire economy,  $O_i := \sum_{i'=1}^N \omega_{i',i}$ . The last column of Table 1.1 reports the weighted out-degree for each sector. The most important industries in the 34-sector economy are Services, Trade, Chemicals, and Finance Insurance and Real State.

### 1.5.3 Frequency of price changes

To calibrate the frequency of price change in the 34-sector economy I use data from Pasten et al. (2016b). These authors calibrate monthly frequencies of price changes using confidential microdata underlying the BLS’s Producer Price Index (PPI). They calculate the frequency of price adjustments at the goods level and aggregate these goods-based frequencies to a 350-sector industry level. This is done according to the industry definitions of the Bureau of Economic Analysis (BEA), which maps approximately to the 4-digits NAICS code

aggregation level. I produce the 34-sector frequencies by: (i) mapping the 4-digit NAICS codes to the 2-digit SIC codes using the guidelines provided by the BEA, and (ii) by computing the median frequency within each 2-digit SIC code. This procedure yields an average monthly frequency of 21.1%, corresponding to an implied duration of prices of 4.2 months. Finally, since in the rest of the paper the unit of time is quarterly, I express the frequencies of price change computed in this section also by quarter.

#### 1.5.4 *Other parameters*

**Business cycle parameters.** The rest of the model’s parameters are set equal to standard values from the business cycle literature. The unit of time is a quarter so the subjective discount factor is set equal to  $\beta = (0.967)^{\frac{1}{4}}$  to target the average of the 1-Year Treasury Constant Maturity Rate between 1962 and 2016. The coefficient of relative risk aversion is  $\sigma = 1$ , and the inverse of the Frisch elasticity of labor is  $\varphi = 1$ . The parameters of the Taylor rule are  $\rho_I = 0.8$ ,  $\phi_c = 0.5/4$  and  $\phi_{\Pi} = 2$  similar to those estimated in Smets and Wouters (2007). The autoregressive coefficient and quarterly standard deviation of the aggregate productivity shock and aggregate monetary shock are  $\rho_p = 0.95$ ,  $\sigma_p = 0.45$ ,  $\rho_m = 0.15$  and  $\sigma_m = 0.24$ , respectively (as estimated in Smets and Wouters 2007). Finally the constant elasticity of substitution is set equal to  $\epsilon = 7$ . Table 1.2 summarizes the values of these parameters.

**Five different economies.** I use the baseline calibration described above to compare a standard one-sector model with a multi-sector economy with production networks and heterogeneous frequencies of price change. To build an intuition of how different dimensions of sectoral heterogeneity affect the results, I introduce three intermediate cases, each one seeking to highlight a key feature of the model. Table 1.3 reports the details of the 5 cases, but I state the main characteristics below:

**Case 1:** one-sector model, no production networks, homogeneous frequencies of price change

**Case 2:** multi-sector model, no production networks, homogeneous frequencies of price change

**Case 3:** multi-sector model, no production networks, heterogeneous frequencies of price change

**Case 4:** multi-sector model, production networks, homogeneous frequencies of price change

**Case 5:** multi-sector model, production networks, heterogeneous frequencies of price change

Case 1 is the standard NK model. Case 2 only increases the number of sectors. Case 3 introduces differences in price stickiness across sectors. Case 4 is similar to Case 2 but it adds input-output links between sectors. Case 5 combines the different types of heterogeneity.

## 1.6 Inflation Dynamics

In this section I discuss how the multi-sector model with heterogeneity compares to the standard one-sector model in terms of inflation sensitivity with respect to aggregate output gap and inflation inertia. The sensitivity of inflation to the output gap is important for many reasons. First, from a policy perspective, inflation sensitivity to the output gap gives a sense of how does real activity affects inflation. For example, given a positive output gap, higher sensitivity would mean higher inflationary pressures and would prompt monetary authorities to raise interest rates more quickly. Secondly, inflation sensitivity to the output gap is inversely related to the magnitude and persistence of the real effects of monetary shocks.<sup>6</sup> When inflation is less sensitive to movements in real activity and thus aggregate price adjustments take longer to occur, the slower adjustment feeds back to aggregate output, adding sluggishness to the convergence process. On the other hand, inflation inertia has similar implications in terms of slowing the price adjustment process and amplifying the real effects of monetary shocks. The backward-looking nature of within-sector price dispersion (Equation (1.23)) and relative sectoral prices (Equation (1.28)) adds inertia to the equilibrium system. Although the within-sector measure of price dispersion is also present in a one-sector model with trend inflation, relative sectoral prices are, by definition, only relevant in a model with more than one sector.

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6. See Woodford (2011) Chapter 3 for a detailed discussion of the one-sector model.

### 1.6.1 The generalized New Keynesian Philips Curve

To give a measure of the sensitivity of inflation to the output gap, I derive the generalized NKPC. I call the equation linking inflation to output gap the “generalized NKPC” because it embeds several versions of the NKPC found in the literature.<sup>7</sup> Appendix 1.C.1 shows how to produce the NKPC from the log-linearized equilibrium system. I also derive the NKPC of two special cases to highlight the main differences with the standard one-sector model.

**Generalized NKPC.** The generalized NKPC from the model laid out in Section 1.3 and Section 1.4 is given by

$$\begin{aligned} \hat{\Pi}_t = & \Phi_c \hat{C}_t + \sum_{i=1}^N \{ \Phi_i^p \hat{p}_{i,t} + \Phi_i^s \hat{s}_{i,t} \\ & + \beta \Phi_i^\pi \mathbb{E}_t [\hat{\Pi}_{i,t+1}] + \beta \Phi_i^\psi \mathbb{E}_t [\hat{\psi}_{i,t+1}] + \Phi_i^z z_{i,t}^p \}, \end{aligned} \quad (1.39)$$

where variables with hat denote log-deviations with respect to their steady state levels, i.e.  $\hat{X}_t := \log X_t - \log \bar{X}$ . The coefficients  $\Phi_c, \{ \Phi_i^\pi, \Phi_i^\psi, \Phi_i^p, \Phi_i^s, \Phi_i^z \}_{i=1}^N$  depend only on parameters of the model and are defined in Appendix 1.C.1. Equation (1.39) shows that, contrary to the standard NKPC, aggregate inflation depends on a number of endogenous variables other than future expected inflation and the aggregate output gap. Expectations of the present value of future sectoral marginal costs  $\mathbb{E}_t [\hat{\psi}_{i,t+1}]$ , relative sectoral price gaps  $\hat{p}_{i,t}$  and sectoral price dispersion gaps  $\hat{s}_{i,t}$  are all endogenous variables that also affect aggregate inflation and are ignored in a simpler model.

There are several implications from the generalized NKPC in (1.39). First is the coefficient of the output gap changes relative to the one-sector economy. This is analyzed below. Second is the log-linearized version of equations (1.23) and (1.28) include the variables  $\{ \hat{p}_{i,t}, \hat{s}_{i,t} \}_{i=1}^N$  into the aggregate NKPC adds inertia to the inflationary process since these variables are backward looking (see equations (1.59) and (1.61) in Appendix 1.B.2). Third, the heterogeneity of the model implies that some sectors are relatively more impor-

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7. Sections 1.C.1 to 1.C.1 of the Appendix show how different versions of the NKPC can be obtained as special cases of the generalized NKPC.

tant in determining inflation. Finally, the presence of endogenous variables other than the output gap can bias the estimated coefficients of a standard NKPC if the omitted variables are correlated with those included in the estimation.

**NKPC under no trend inflation.** To build some intuition about the magnitude of the coefficient  $\Phi_c$  equation (1.40) presents the NKPC in the case with no trend inflation,<sup>8</sup> i.e.  $\bar{\Pi}_i = 1$ . Without trend inflation the coefficients of future expected marginal costs  $\Phi_i^\psi$  converge to zero while the within-sector price dispersion measures  $\hat{s}_{i,t}$  are no longer relevant in a first-order approximation of the system.

$$\hat{\Pi}_t = \Phi_c \hat{C}_t + \beta \mathbb{E}_t \left[ \hat{\Pi}_{t+1} \right] + \sum_{i=1}^N \left[ \Phi_i^p \hat{p}_{i,t} + \Phi_i^z z_{i,t}^p \right] \quad (1.40)$$

In this case the coefficients  $\{\Phi_i^p, \Phi_i^z\}_{i=1}^N$  are different from the values taken in (1.39) and are defined in Appendix 1.C.1. Note that relative price gaps are still present in the NKPC so even under zero trend inflation the equation includes the backward-looking variables.

**Standard NKPC** The standard NKPC can be produced from (1.40) by assuming  $N = 1$  and setting  $\delta = 1$  to keep the constant returns to scale. Under these assumptions the NKPC becomes

$$\hat{\Pi}_t = \Phi_c \hat{C}_t + \beta \mathbb{E}_t \left[ \hat{\Pi}_{t+1} \right] + \Phi^z z_t^p, \quad (1.41)$$

and by definition there are no sectoral price gaps. The next section compares the coefficients of the output gap.

The sensitivity of inflation towards the aggregate output gap

The value of the coefficient  $\Phi_c$  varies depending on the parameters of the model. Under the more general case of equation (1.39),  $\Phi_c$  involves weighted averages of sectoral inflation

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8. This statement is about sectoral trend inflation. Technically one could have a case where sectors have different trend inflation rates that cancel out in the aggregate. Equation (1.40) would not be valid in that case.

trends, price stickiness and measures of sector centrality. The precise formula is presented in Appendix 1.C.1.

Figure 1.3a displays the coefficient  $\Phi_c$  for the standard one-sector economy and the multi-sector economy for 3 different values of trend inflation. The figure shows two important characteristics. For each case,  $\Phi_c$  is decreasing with the level of trend inflation, implying the inflation gap reacts less to a given level of the output gap. Second, for any level of trend inflation the multi-sector economy always displays a lower value of  $\Phi_c$ . Figure 1.3b compares the value of  $\Phi_c$  for the 5 cases described in Table 1.3. Case 3 in the figure shows that adding only the heterogeneity of price stickiness increases  $\Phi_c$ , making inflation more sensitive to output-gap variations. However Case 4 shows the isolated effect of adding production networks:  $\Phi_c$  at about 60% compared to the one-sector economy of Case 1. The final effect of these two forces can be observed in Case 5. At an inflation trend of 2%, the coefficient of Case 5 is about 30% smaller than that of Case 1.

## Sectoral NKPC coefficients

The generalized NKPC of equation (1.39) includes several sectoral variables. In this section I briefly analyze some of the coefficients of these variables. For this analysis Figures (1.4) and (1.5) report a scatter plot of the coefficients of relative price gaps and sectoral price dispersion gaps, respectively. Table (1.4) reports correlations between sectoral coefficients and sectoral measures of price stickiness and network centrality. These figures and table are useful to isolate key characteristics of each type of coefficient, which are discussed below.

**Relative price gap coefficients,  $\Phi_i^p$ .** First we have the coefficients associated with sectoral price gaps,  $\{\Phi_i^p\}$ . Equation (1.40) shows that sectoral price gaps are also relevant in a setting without trend inflation. Since sectoral price gaps are defined as the log-difference of relative sectoral prices with respect to their steady state level, these variables are only relevant in multi-sector models. Figure 1.4 displays the coefficients  $\Phi_i^p$  for the economies described in Cases 2 to 5 when there is no trend inflation. In Case 2 every sector has a negative coefficient equal to  $-0.02$ , meaning that a positive sectoral price gap of 1% would decrease inflation by 2bp, reflecting expectations of that sector closing its gap in the fu-

ture. Compared to Case 2, Case 3 only introduces heterogeneity in the frequency of price stickiness. Figure 1.4a shows that heterogeneity increases dispersion of the coefficients, and columns (a) and (b) of Table 1.4 indicate that more flexible sectors (i.e. sectors with lower  $\theta_i$ ) have negative coefficients with bigger absolute value.

To isolate the effect of having production networks, we can compare Case 2 and Case 4 in Figure 1.4b. Just by adding production networks, the coefficients  $\Phi_i^p$  increase, some of them even taking positive values. The change in sign may be due to a substitution of a sector's output in the production chain; a positive sectoral price gap would make other sectors substitute inputs normally bought from the sector with higher prices, increasing the current cost of production and hence inflation. The positive correlation in column (a) of Table 1.4 shows that this effect is more important for more central sectors.

The total effects of these forces are reflected in the coefficients of Case 5 in Figure 1.4. In the calibrated economy of Case 5, the magnitude of the negative coefficients is dampened relative to Case 3, while the magnitude of some positive coefficients is amplified relative to Case 4. Tables 1.5 and 1.6 show the coefficients for the calibrated economy of Case 5, when trend inflation is 0% and 2% respectively. Agriculture and Metal Mining are the most important sectors with negative price coefficients. Without trend inflation Table 1.5 shows that a positive 1% price gap in those sectors would trigger a decrease in inflation of 22bp and 26bp in the agriculture and metal mining sectors, respectively.

**Within-sector price dispersion gap coefficients,  $\Phi_i^s$ .** Another important set of coefficients is that associated with within-sector price dispersion gaps,  $\{\Phi_i^s\}$ . Figure 1.5 shows these coefficients in decreasing order when trend inflation is zero. The coefficients are positive for all the cases analyzed, implying that positive (negative) within-sector price dispersion gaps trigger increases (decreases) in aggregate inflation. Comparing Case 2 and Case 3 in Figure 1.5a shows the effect of heterogeneity of price stickiness. Again, the heterogeneity of Case 3 amplifies the dispersion of the coefficients. Columns (c) and (d) of Table 1.4 show that this is due to sectors with more flexible prices having higher coefficients. On the other hand, comparing Case 2 and Case 4 in Figure 1.5b, one can see that the effect of adding production networks dampens the magnitude of the coefficients. Although more central sec-

tors have higher coefficients according to columns (c) and (d) in Table 1.4, their magnitude is small compared to Case 2. As a result the calibrated economy of Case 5 looks like a less extreme version of Case 3. Tables 1.5 and 1.6 show that again Agriculture and Metal Mining are the most relevant sectors. Without trend inflation, a 1% gap in within-sector price dispersion would cause an increase in inflation of 10 bp in the case of Agriculture and 9bp in the case of Metal Mining (Table 1.5).

**Other sectoral coefficients.** An analysis similar to the one above shows that the coefficients of sectoral productivity shocks are driven by forces similar to those determining the within-sector price dispersion coefficients. Positive productivity shocks decrease inflation, and they do so more in central sectors with more flexible prices (see Figure 1.6 and columns (e) and (f) in Table 1.4). Again, heterogeneity of price stickiness appears to be the main force driving quantitative differences across sectors. With respect to the other coefficients present in the generalized NKPC (1.39), Tables 1.5 and 1.6 show two things. First, there is no sectoral variation in the coefficients of future expected sectoral inflation  $\Phi_i^\pi$ . This is mainly explained by assuming the same inflation trend and consumption shares across sectors. Second, the coefficients linked to discounted marginal costs,  $\Phi_i^\psi$  are quantitatively not important. Finally, by comparing the summary statistics at the bottom of Tables 1.5 and 1.6, we see that increases in trend inflation decrease the overall importance of  $\Phi_i^p$ ,  $\Phi_i^s$ , and  $\Phi_i^z$  while increasing the overall importance of  $\Phi_i^\pi$ ,  $\Phi_i^\psi$ . Thus the NKPC becomes more forward looking as trend inflation increases.

### 1.6.2 Impulse response functions

The analysis of the previous section provides some suggestive evidence of what differences should be expected when comparing the dynamic properties of inflation in a one-sector model with a multi-sector one. Compared to a one-sector model, inflation in a multi-sector model reacts less to variations in aggregate output and should have more inertia because of the presence of relative sectoral price gaps, which follow a backward looking process. This analysis is, however, a partial one since the output gap and sectoral variables such as relative price gaps are all endogenous variables of the dynamic equilibrium system. This

section presents the impulse response functions of aggregate inflation and the aggregate output gap to different types of exogenous shocks.

## Real effects of monetary shocks

To measure the real effects of monetary shocks Figure 1.7a compares the impulse response functions of the one-sector and the multi-sector economies to a 1% annualized monetary shock. Just as expected from the the analysis in Section 1.6.1, the real effects of monetary shocks are more important in the multi-sector case. Compared to the one-sector economy, inflation reacts less to the monetary shock in the multi-sector economy of Case 5 and as a result the response of the output gap is larger, increasing the degree of monetary non-neutrality. This can also be seen in Table 1.7 that shows the impulse response at impact and the cumulative effect after 4 quarters for both the output-gap and inflation.

Under the baseline calibration of the model, trend inflation does not play a large role in modifying these impulse response functions. The dashed lines of Figure 1.7a, representing the responses when trend inflation is 4%, are very similar to the solid lines, representing the responses when trend inflation is 0%.<sup>9</sup> Table 1.7 shows that impulse responses at impact and after 4 quarters are very similar across values of trend inflation. Maybe a more important consequence of higher trend inflation is the fact that, for values of trend inflation above 4%, the multi-sector model of Case 5 does not have a unique equilibrium. Since the same phenomenon holds true for the multi-sector economy of Case 3, this suggests that multiple equilibria are a consequence of adding heterogenous degrees of price stickiness into the model.

Finally, Figure 1.7b and Table 1.7 allow for the comparison of how different characteristics affect the responses of inflation and output gap to a monetary shock. Facing a monetary shock, the multi-sector economy of Case 2 displays the same dynamics of the one-sector economy. Since the economy is only facing an aggregate shock and, in Case 2 all sectors can adjust their prices at the same speed, having one or multiple sectors does not affect the

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9. These results change depending on the calibration of the model. For example, higher values for the elasticity of substitution  $\epsilon$  increase the degree of monetary non-neutrality in cases with larger trend inflation. For the baseline calibration the effects of trend inflation can be observed in the one-sector model at higher levels of this variable (see Figure 1.8). However, as discussed in this section, higher levels of trend inflation trigger multiple equilibria in the multi-sector economy of Case 5.

dynamic results. On the other hand, Figure 1.7b shows that Cases 3, 4, and 5 display similar dynamic responses to the aggregate shock. Table 1.7 shows that the responses in Case 5 at impact and after the 4th quarter are mainly explained by the production network introduced in Case 4. For example, when trend inflation is 0% annually, the output gap drops 0.34% in the standard one-sector economy (Case 1) compared to 0.57% in the calibrated multi-sector economy (Case 5). Adding only price stickiness heterogeneity (Case 3) would produce a drop of 0.43% whereas adding only production networks (Case 4) would produce a drop of 0.50% , closer to the value observed in the calibrated multi-sector economy.

## Inflation inertia

The presence of backward-looking variables in the generalized NKPC adds inertia to the inflationary process. To illustrate this, Figure 1.9 displays the correlograms for Cases 1 and 5. The correlograms are estimated after solving each model and performing a MonteCarlo simulation with 10,000 repetitions of 180 periods each. The simulations assume productivity and monetary shocks according to the calibration in Section 1.5. Figure 1.9 displays the results without trend inflation. We can see that, compared to Case 1, the autocorrelation of inflation increases in the multi-sector model.

## 1.7 Trend inflation, welfare, and monetary policy

This section compares the welfare costs of trend inflation between the standard one-sector model and the multi-sector model with heterogeneity. To measure welfare costs I compute the consumption equivalent,  $CE$ , that is the fraction by which consumption must be increased in an equilibrium with price frictions as to produce the same expected utility of a flexible price equilibrium. The consumption equivalent is implicitly defined by:

$$\mathbb{E} [U (L_{\bar{\Pi}}, C_{\bar{\Pi}} (1 + CE))] = \mathbb{E} [U (L_F, C_F)], \quad (1.42)$$

where  $L_{\bar{\Pi}}, C_{\bar{\Pi}}$  are optimal labor and consumption in an economy with price frictions and trend inflation equal to  $\bar{\Pi}$ , and  $L_F, C_F$  are optimal labor and consumption in the flexible

price equilibrium. To compute the consumption equivalent I solve the model and perform a Montecarlo simulation with 10,000 repetitions of 180 periods each, which corresponds to the sample size used to calibrate the parameters of the productivity shocks in Section 1.5 . This procedure allows me to compute expected utility and solve for the consumption equivalent. In the section below, I solve and simulate the model for Cases 1 to 5 to analyze the components of welfare costs associated with trend inflation.

### 1.7.1 *Welfare costs*

Figure 1.10a displays welfare costs as a function of trend inflation for the one-sector economy of Case 1 and the calibrated multi-sector economy of Case 5. The differences are stark. Although both models predict similar costs when trend inflation is zero, the costs rise sharply in the multi-sector model. When trend inflation is 2% annually, the one-sector model displays a welfare cost of 0.03% compared to the welfare cost of 0.34% of the multi-sector model, increasing the losses by one order of magnitude. At a 4% level of trend inflation, the losses are 0.10% in the one-sector model versus 2.28% in the multi sector model. For values of trend inflation above 4% annually a unique equilibrium of the multi-sector model of Case 5 does not exists. I discuss this fact below in this section.

To shed a light on the sources of these differences, Figure 1.10a and Table 1.8 present the welfare costs for the all cases described in Table 1.3. Several things are worth noticing. First, and differently from the results of Section 1.6, the one-sector economy (Case 1) and the multi-sector economy without production networks and homogeneous price stickiness (Case 2) do not yield the same results. Although the impulse response functions of these two cases were almost the same when facing an aggregate shock (see Figure 1.8 and Table 1.7), the welfare costs of trend inflation are larger in Case 2. This difference is partly explained by the presence of sectoral shocks in the simulations of Case 2; even though all sectors can react at the same speed to aggregate shocks, the presence of sectoral shocks under nominal frictions distorts relative sectoral prices. The results for Case 3 show that adding heterogeneity in price stickiness to a multi-sector model without production networks amplifies these distortions even further. In fact, the distortions produced in Case 3 almost match those of the fully calibrated economy of Case 5. Furthermore, just as in Case 5, Case 3 does not have a unique

equilibrium for trend inflation above 4%. This points to heterogeneity in price stickiness as the source of equilibrium instability as trend inflation increases. Finally, the case of a multi-sector economy with production networks but homogeneous price stickiness across sectors (Case 4), yields higher welfare losses than the homogeneous case without production networks. Thus production networks do amplify the welfare costs of trend inflation but do not represent the most important amplification factor.

Sources of welfare costs.

**Steady state inefficiencies.** To understand the sources of welfare costs Figure 1.11 illustrates the effect of trend inflation on steady state consumption and labor. Compared to the flexible price equilibrium, steady-state consumption drops sharply in the multi-sector economy of Case 5, whereas the decrease is much less pronounced in the standard one-sector model of Case 1. In Case 5, with trend inflation equal to 2%, steady-state consumption drops 0.25% with respect to its flexible price level. The same value is much lower for Case 1, where steady-state consumption drops 0.02% with respect to its flexible price level. On the other hand, steady-state labor increases more rapidly in Case 5 compared to Case 1 ( 0.11% versus 0.01% with trend inflation of 2%). As a result, with trend inflation of 2% aggregate *TFP* drops 0.36% in Case 5 compared to the 0.02% drop of Case 1.

From the analysis of Section 1.4.1 we know that *TFP* is a function of endogenous variables of the model and structural parameters. But how can we give a quantitative measure of the individual significance of these forces affecting *TFP*? We can compare the different cases in Figure 1.12 to answer this question. The figure shows that the multi-sector economy with homogeneous price stickiness and no production networks (Case 2) produces similar results than the standard one-sector economy. Compared to this case, Case 4 shows that introducing production networks does increase *TFP* losses, particularly at higher levels of trend inflation. However, what seems to be quantitatively crucial in creating productivity losses is introducing heterogeneity in the degree of price stickiness across different sectors (Case 3). Comparing *TFP* losses for Cases 3 and 5, we infer that production networks play only a minor role in amplifying *TFP* losses after accounting for heterogeneity of price stickiness.

It has been argued before that the within-sector price dispersion measure,  $s_i = \int_0^1 \left( \frac{P_{i,t}^{(i,j),t}}{P_{i,t}} \right)^{-\epsilon} dj$ , causes inefficiencies that mimic those of productivity losses (Yun, 2005) and that those inefficiencies become quantitatively more important with higher trend inflation (Ascari and Sbordone, 2014). The analysis in this section shows that losses caused by within-sector price distortions are only secondary to those coming from distortions changing sectoral relative prices.

**Volatility increases.** The second type of source of welfare costs is the effect that trend inflation has on the volatility of labor and consumption. Because of risk aversion, expected utility is decreasing in the variance of these variables. As shown in Table 1.9 trend inflation increases the annualized standard deviations of both variables. Again, the increase is sharper in the case of the multi-sector economy. When trend inflation increases from 0% to 4% the standard deviation of consumption increases 6bp in the standard one-sector model versus 45bp in the calibrated multi-sector one. In the case of labor, an increase in trend inflation going from 0% to 4% generates an increase in the standard deviation of 13bp in the standard one-sector model compared to a 54bp increase in the calibrated multi-sector model of Case 5. I conclude that higher trend inflation increases the volatility of consumption and labor for both the one-sector and the multi-sector models, but the effect is proportionally more important for latter case, hence explaining the welfare results. This result is particularly relevant for current discussions about optimal inflation targeting since it highlights how welfare costs of inflation are larger in multi-sector models even at moderate levels of inflation.

### 1.7.2 Monetary Policy

**Monetary policy and trend inflation.** The volatility results of the previous section may be particularly sensitive to the parameters  $\phi_c$  and  $\phi_\pi$  used in the Taylor rule given by equation (1.8). To study how trend inflation affects the volatility of labor and consumption for different combinations of these parameters I perform the following exercise. First, I define a grid for the possible values that parameters  $\phi_c$  and  $\phi_\pi$  can take. Then for each possible combination  $(\phi_c, \phi_\pi)$  of this grid, I solve the system and perform a Montecarlo simulation

similar to the one described at the beginning of this section. The resulting combinations of standard deviations  $(\sigma_C, \sigma_L)$  are illustrated in Figure 1.13 for trend inflation ranging from 0% to 4%.

A few things are worth noticing in this figure. First, at the lowest level of trend inflation, the clusters of feasible points  $(\sigma_C, \sigma_L)$  of Cases 1 and 5 overlap. This implies neither the one-sector economy nor the multi-sector economy clearly offer lower feasible combinations  $(\sigma_C, \sigma_L)$ . However, this changes when trend inflation equals 2% since the cluster of points of the multi-sector economy tends to be above that of the one-sector economy. Thus the multi-sector economy offers worse volatility combinations, something that would be reflected in lower welfare. When trend inflation equals 4%, the multi-sector economy is clearly dominated by the one-sector economy; for any given value of  $\sigma_L$ , the feasible value of  $\sigma_C$  is higher in the multi-sector economy of Case 5. Notice also how the cluster of feasible points of Case 5 decreases as trend inflation increases due to the fact that higher trend inflation makes finding a unique equilibrium less likely, everything else constant. I conclude that trend inflation worsens the possible combinations  $(\sigma_C, \sigma_L)$  that a monetary authority could target, and this phenomenon becomes proportionally more relevant in the multi-sector economy.

To draw the previous conclusion I compared simulations done with different shocks.<sup>10</sup> To isolate the differences that may be caused by having different productivity processes, it is useful to compare Cases 2 and 5, since these cases use the same shock structure for simulations. As seen in the previous sections, Case 2 tends to generate very similar results as the one-sector economy since, other than the productivity shocks, the only difference between those two cases is the number of sectors. Comparing Case 2 and Case 5 in Figure 1.13 makes it clear how the heterogeneity of Case 5 generates worse volatility combinations and less stable equilibria: the cluster of points of Case 5 is always to the north-east relative to Case 2, and the distance between the remaining points increases as trend inflation increases.

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10. As explained in Section 1.5, the one-sector model uses only 2 shocks: an aggregate monetary shock and an aggregate productivity shock. Although the multi-sector model uses the same monetary shock, it introduces sectoral productivity shocks. These two different shock processes yield similar moments for consumption, labor and inflation under the baseline calibration.

**Monetary policy and the business cycle.** To understand the challenges associated with monetary policy in the calibrated multi-sector economy Figures 1.14 and 1.15 present a comparison of the feasible pairs  $(\sigma_C, \sigma_\pi)$  for the grid of policy parameters  $(\phi_c, \phi_\pi)$ . An exercise like this is relevant for monetary authorities seeking to minimize ad hoc welfare losses of the type

$$\mathcal{L} = \chi \sigma_\pi^2 + (1 - \chi) \sigma_c^2, \quad (1.43)$$

for  $\chi \in [0, 1]$ . Figure 1.14 shows that the cluster of points in the one-sector economy is not greatly affected by the level of trend inflation, implying that an optimal solution to (1.43) may not vary much with the level of trend inflation. On the other hand, in the case of the calibrated multi-sector economy, the results are similar to the  $(\sigma_C, \sigma_L)$  frontier. At lower levels of trend inflation the cluster of feasible volatility combinations in the one-sector model and the calibrated multi-sector model overlap. As trend inflation increases the cluster corresponding to the multi-sector economy shifts right, and finding unique equilibria becomes less likely. Note that this does not happen for the multi-sector economy with homogeneous price stickiness and no production networks (Case 2). Again, the results for this case are similar to the one-sector economy in the sense that trend inflation does not alter much the cluster of feasible volatility combinations. A comparison of Cases 2 and 5 highlights the effect of heterogeneity holding the shock structure constant; the heterogeneity of Case 5 worsens the trade-off between inflation and output volatility and makes equilibria less stable.

Finally, to understand what dimensions of heterogeneity drive the latter result, Figure 1.14 displays the feasible frontiers for the other cases described in Table 1.3.

Figure 1.15a highlights how heterogeneity of price stickiness does not greatly affect the level of the feasible volatility combinations but it does affect the existence of equilibria. This comes from comparing Cases 2 and 3 that only differ in the heterogeneity of price stickiness. Case 3 displays clusters of points at similar levels than Case 2, but the cluster of feasible points shrinks as trend inflation increases.

On the other hand Figure 1.15b emphasizes how production networks amplify the volatility levels. We can draw this conclusion by comparing Case 2 and Case 4, which only differ

in having production networks. The cluster of points related to Case 2 offer higher standard deviations of output for each level of standard deviation of inflation. As trend inflation increases both clusters of Cases 2 and 4 move to the right, but the movement is quantitatively more important in the economy with production networks of Case 4.

**Alternative Taylor rules.** By targeting the aggregate inflation rate, the Taylor rule of equation (1.8) implicitly weights sectoral inflation rates using consumption shares. A natural question to ask is whether this is the best inflation measure to track. Related to this question, Aoki (2001) argues that in a model with two sectors, one with sticky prices, the other one with flexible prices, the optimal monetary policy is to target sticky-price inflation. The paper argues that stabilizing the inflation rate of the sticky-price sector is sufficient to maintain the relative price at its efficient value. However, in a multi-sector model with heterogeneity of price stickiness the optimal inflation measure becomes less clear. To explore how different inflation measures affect the feasible pairs  $(\sigma_C, \sigma_\pi)$  that may be relevant for minimizing an ad hoc loss like in (1.43) I solve and simulate the model with the following alternative Taylor rule,<sup>11</sup>

$$\hat{I}_t = \rho_I \hat{I}_{t-1} + (1 - \rho_I) \left[ \phi_c \hat{C}_t + \phi_\pi \hat{\Pi}_t^{alt} \right] + z_t^p \quad (1.44)$$

where

$$\hat{\Pi}_t^{alt} := \sum_{i=1}^N \alpha_i^{alt} \hat{\Pi}_{i,t}. \quad (1.45)$$

The alternative inflation measure  $\hat{\Pi}_t^{alt}$  is defined according to (1.45). In the two-sector case studied in Aoki (2001),  $\alpha_{sticky}^{alt} = 1$  and  $\alpha_{flexible}^{alt} = 0$ , so the inflation target corresponds to the sticky sector.

In this spirit I study two different possibilities. First, I define the weights as a normalized measure of price stickiness,  $\alpha_i^{alt} = \frac{\theta_i}{\sum_{i=1}^N \theta_i}$ . Second, I adjust by the weighted out-degree of each sector,  $\alpha_i^{alt} = \frac{\theta_i O_i}{\sum_{i=1}^N \theta_i O_i}$ . Then, I solve and simulate the model for different combinations

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11. This corresponds to the log-linearized version of equation (1.8).

of the parameters  $(\phi_\pi, \phi_c)$ . The results are reported in Figure 1.16 and Figure 1.17 for the economy described in Case 5. The cluster of resulting points is then compared to the cluster produced by the standard Taylor rule, i.e. using  $\alpha_i^{alt} = \alpha_i$ .

The results show that the the cluster of points produced by these types of Taylor rules are largely similar and sometimes offer worse volatility combinations than the standard Taylor rule that targets aggregate inflation. This result is not surprising since the ability of the monetary authority to affect relative prices in the multi-sector model is severely limited by using a monetary tool – the interest rate – that is common to every sector.

## 1.8 Conclusions

This paper shows that a disaggregated analysis of a monetary economy captures several important elements that are relevant for monetary policy. Compared to a one-sector model, the relationship between inflation and output is flatter, and different types of sectoral distortions play a role in determining inflation. Sectors with more flexible prices and which are more central in the production network become more important in determining inflation.

This flatter relationship between inflation and output affect the trade-off faced by monetary authorities seeking to minimize inflation and close output-gaps. Monetary policy becomes harder to implement, in the sense that the same set of policy tools yields worse outcomes in terms of variance of inflation, output, and labor. Trend inflation can amplify these effects and make equilibria less stable, something that should be carefully analyzed when studying dynamic responses to different shocks.

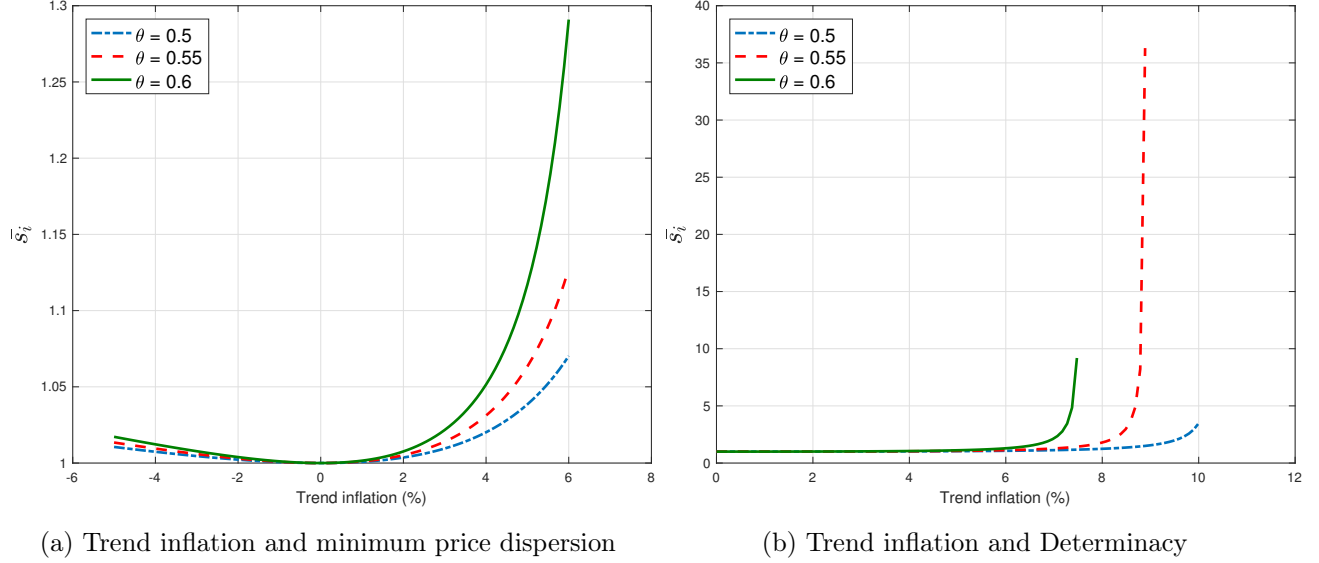
Furthermore, the paper analyzes Taylor rules with alternative measures of inflation targets in the multi-sector model. Relative to a standard Taylor rule, the alternative rules are not effective in decreasing the volatility of consumption and inflation. This highlights the difficulty of stabilizing relative price distortions using a monetary tool common to every sector.

The disaggregated analysis of this paper also highlights that trend inflation may be costlier than what an aggregated model without heterogeneity would predict. The welfare losses of trend inflation are amplified relative to an aggregated model, even at moderate levels

of trend inflation. Quantitatively this is caused by distortions in relative sectoral prices associated with higher inflation. The relevance of this type of inefficiency in explaining the welfare costs of higher trend inflation highlights the importance of modeling sectoral heterogeneity in economies with frictions.

## 1.9 Figures and Tables

Figure 1.1: Steady State Within-Sector Price Dispersion



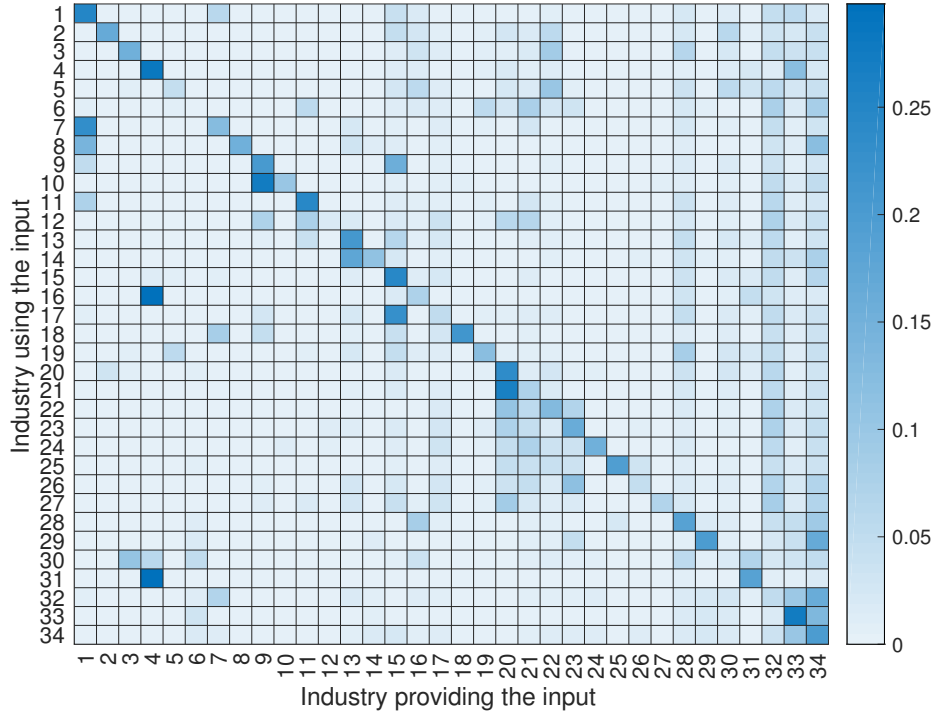
Notes: The figures illustrate the steady state values of the within-sector measure of price dispersion according to equation (1.29). The elasticity of substitution is fixed at  $\epsilon = 7$ . Figure 1.2a shows that  $\bar{s}_i$  is minimized when trend inflation is 0%. Figure 1.2b shows that the determinacy region of  $\bar{s}_i$  shrinks for higher values of the price stickiness parameter  $\theta_i$ .

Table 1.1: Sectoral Productivity Shocks and Intermediate Inputs

Sector	$\rho_i$	$\sigma_{\varepsilon_i} * 100$	$1 - \delta_i$	$O_i$
1. Agriculture	0.72	3.69	0.54	0.79
2. Metal mining	0.83	6.85	0.48	0.21
3. Coal mining	0.94	5.70	0.26	0.29
4. Oil and gas extraction	0.93	5.70	0.27	0.95
5. Non-metallic mining	0.78	4.28	0.28	0.13
6. Construction	0.81	1.46	0.55	0.22
7. Food and kindred products	0.23	1.32	0.69	0.36
8. Tobacco	0.84	5.57	0.48	0.15
9. Textile mill products	0.70	1.67	0.63	0.67
10. Apparel	0.89	1.30	0.64	0.13
11. Lumber and wood	0.82	2.89	0.61	0.48
12. Furniture and fixtures	0.83	1.88	0.52	0.05
13. Paper and allied	0.54	2.31	0.57	0.63
14. Printing, publishing and allied	0.95	2.29	0.43	0.18
15. Chemicals	0.75	2.85	0.53	1.16
16. Petroleum and coal products	0.65	5.99	0.17	0.45
17. Rubber and misc plastics	0.71	2.01	0.53	0.44
18. Leather	0.23	2.48	0.60	0.22
19. Stone, clay, glass	0.91	1.72	0.45	0.31
20. Primary metal	0.85	2.45	0.63	1.08
21. Fabricated metal	0.81	1.60	0.54	0.70
22. Machinery, non-electrical	0.98	3.71	0.56	0.68
23. Electrical machinery	0.98	3.43	0.51	0.58
24. Motor vehicles	0.73	2.81	0.77	0.21
25. Transportation equipment & ordnance	0.39	5.94	0.49	0.22
26. Instruments	0.92	3.03	0.40	0.13
27. Misc. manufacturing	0.79	2.77	0.54	0.10
28. Transportation	0.87	1.87	0.42	1.01
29. Communications	0.92	2.19	0.42	0.37
30. Electric utilities	0.96	2.42	0.20	0.49
31. Gas utilities	0.83	5.55	0.10	0.46
32. Trade	0.77	1.40	0.36	1.55
33. Finance Insurance and Real Estate	0.74	1.43	0.33	1.14
34. Services	0.95	1.44	0.34	1.97

Notes: The table displays the estimated autoregressive coefficients for the sectoral productivity shocks and the standard deviations of the normally distributed shocks according to the methodology explained in Section 1.5.1. For each industry the table also reports the share of intermediate inputs  $1 - \delta_i$  and weighted out-degree  $O_i := \sum_{i'=1}^N \omega_{i',i}$ .

Figure 1.2: Calibrated Production Network



Notes: The figure depicts a heatmap of the calibrated input-output coefficients  $\omega_{i,i'}$  according to the methodology presented in Section 1.5.2 using the *KLEMS* dataset. The definition of economic sectors corresponds to the one in Table 1.1.

Table 1.2: Business Cycle Parameters

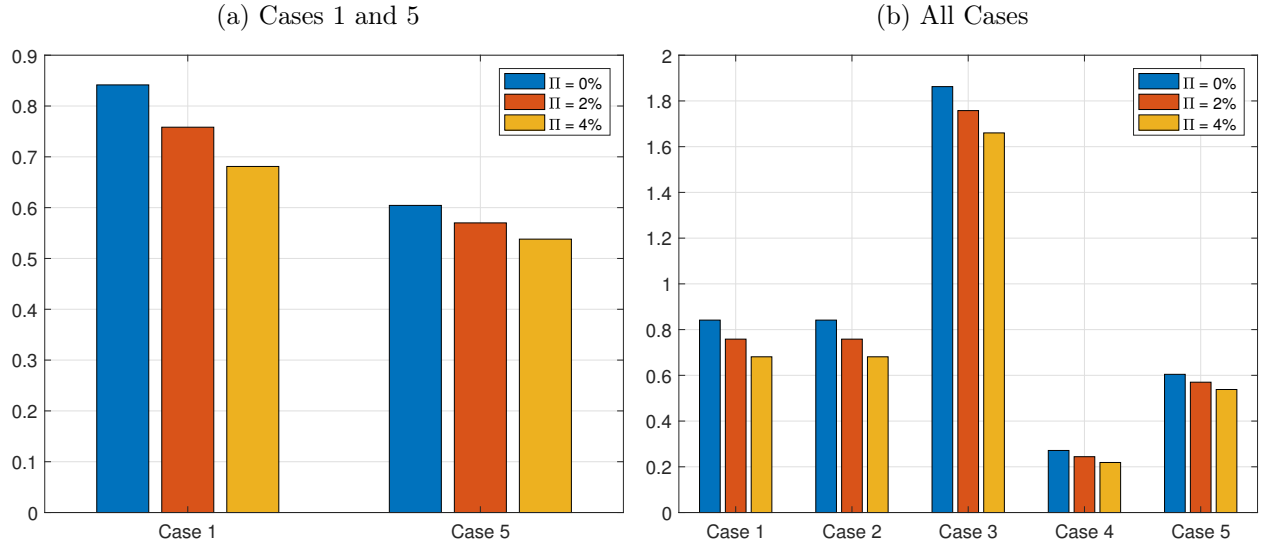
Parameter	Description	Value
$\sigma$	Constant relative risk aversion	1
$\varphi$	Inverse of Frisch elasticity of labor	1
$\epsilon$	Constant elasticity of substitution	7
$\phi_\pi$	Inflationary response of the Taylor Rule	2
$\phi_c$	Output-gap response of the Taylor Rule	$\frac{0.5}{4}$
$\rho_I$	Interest rate smoothing parameter of the Taylor Rule	0.8
$\rho_m$	Autoregressive coefficient of aggregate monetary shock	0.15
$\sigma_m$	Standard deviation of aggregate monetary shock	0.24
$\rho_p$	Autoregressive coefficient of aggregate productivity shock	0.95
$\sigma_p$	Standard deviation of aggregate productivity shock	0.45

Table 1.3: Five different economies

[H] Model	N <sup>o</sup> of Sectors	Production Network	Frequencies	Share of Intermediate Inputs
1. Standard	1	no network	mean frequency, <i>BLS</i>	0
2. No Network, Homogeneous	34	no network	mean frequency, <i>BLS</i>	0
3. No Network, Heterogeneous	34	no network	calibrated frequencies, <i>BLS</i>	0
4. Network, Homogenous	34	calibrated, <i>KLEMS</i>	mean frequency, <i>BLS</i>	calibrated, <i>KLEMS</i>
5. Network, Heterogeneous	34	calibrated, <i>KLEMS</i>	calibrated frequencies, <i>BLS</i>	calibrated, <i>KLEMS</i>

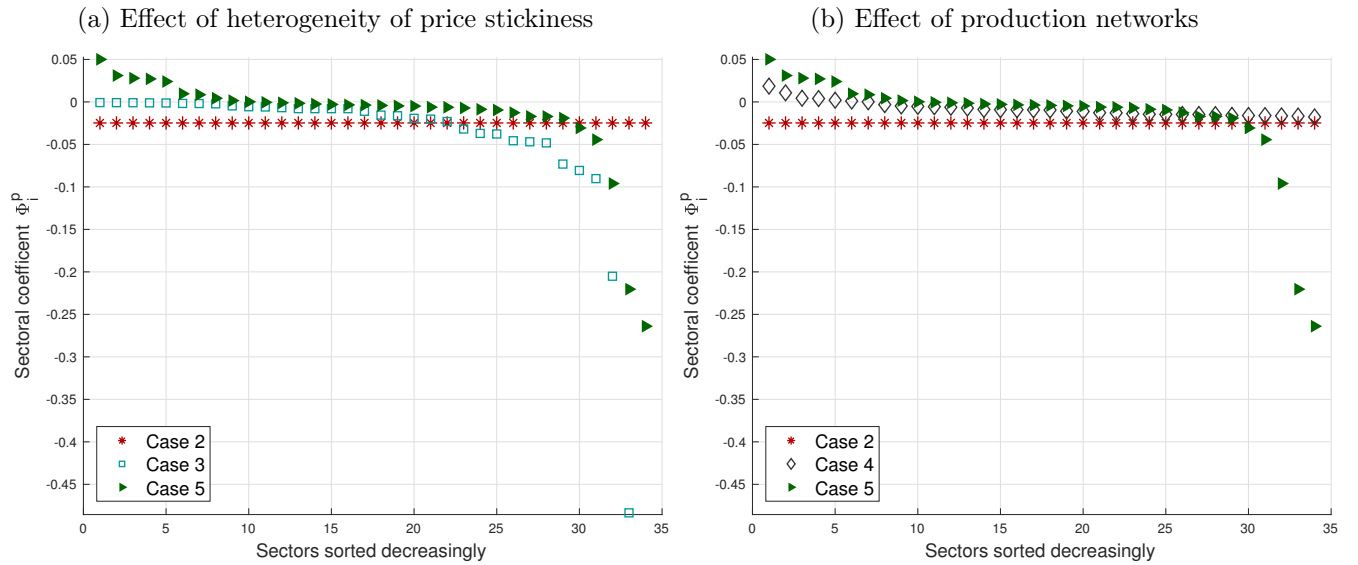
Notes: The table displays the main characteristics of the four different economies studied under the baseline calibration of the model.

Figure 1.3: Sensitivity of Inflation to the output gap



Notes: The figure displays the coefficient  $\Phi_c$  from equation (1.39) for 3 different values of trend inflation and for the 5 different economies detailed in Table 1.3. Case 1 corresponds to the standard one-sector model while Case 5 represents the multi-sector economy. See Table 1.3 for details about the other Cases.

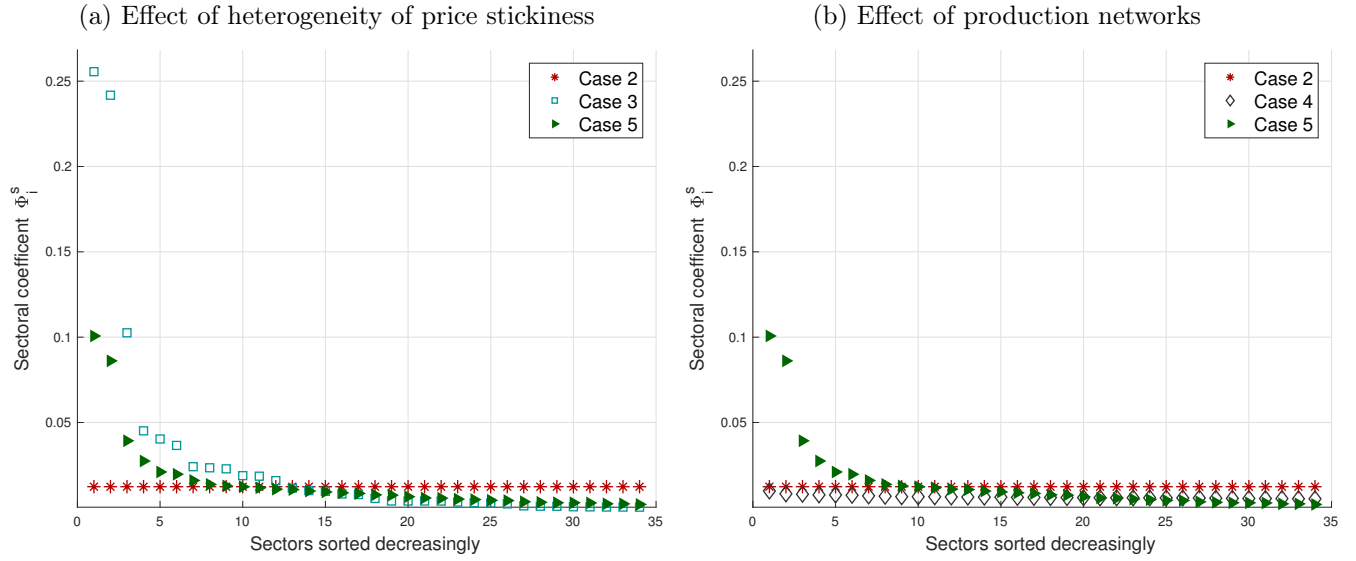
Figure 1.4: Sectoral Price Gap Coefficients,  $\Phi_i^p$



Notes: The figure displays the coefficient  $\Phi_i^p$  from equation (1.39) with no trend inflation under the baseline calibration. Each coefficient indicates the partial response of aggregate inflation to sectoral price gaps defined as  $\hat{p}_{i,t} := \log\left(\frac{P_{i,t}}{P_t}\right) - \log\left(\frac{P_i}{P}\right)$ .

Comparing Case 2 and Case 3 in Figure 1.4a highlights the effect of heterogeneity of price stickiness on the coefficients  $\Phi_i^p$ . Comparing Case 2 and Case 4 in Figure 1.4b highlights the effect of production networks on the coefficients  $\Phi_i^p$ . See Table 1.3 for a complete definition of each case.

Figure 1.5: Within-Sector Price Dispersion Gap Coefficients,  $\Phi_i^s$

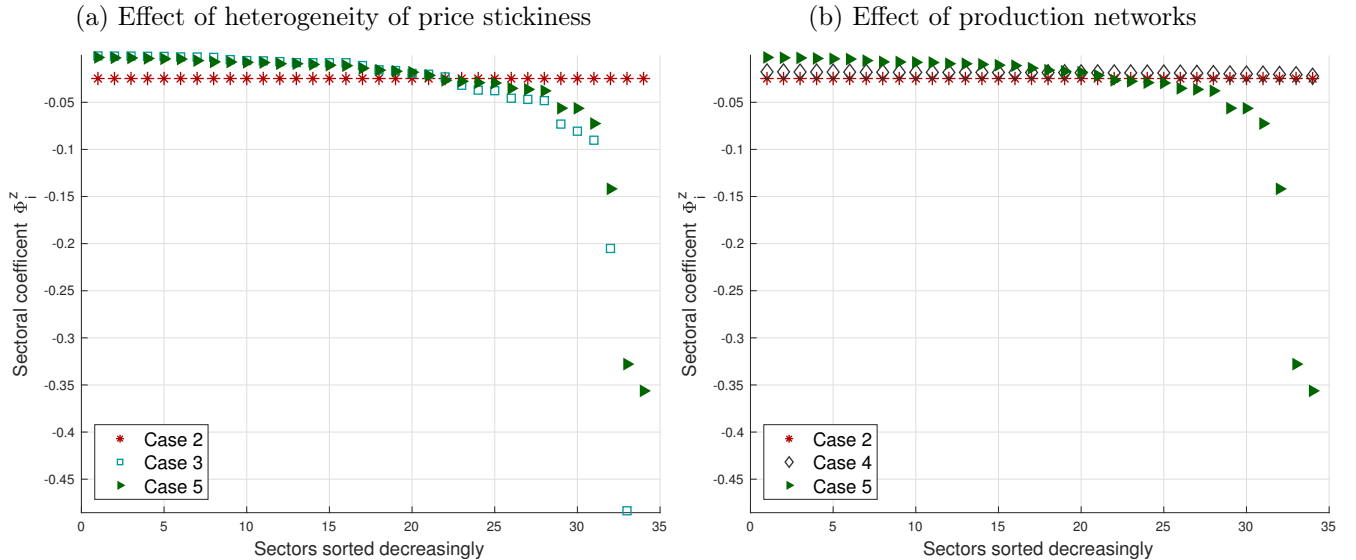


Notes: The figure displays the coefficient  $\Phi_i^P$  from equation (1.39) with no trend inflation under the baseline calibration.

Comparing Case 2 and Case 3 in Figure 1.5a highlights the effect of price stickiness heterogeneity on the coefficients  $\Phi_i^P$ .

Comparing Case 2 and Case 4 in Figure 1.5b highlights the effect of production networks on the coefficients  $\Phi_i^P$ . See Table 1.3 for a complete definition of each case.

Figure 1.6: Productivity Shock Coefficients,  $\Phi_i^z$



Notes: The figure displays the coefficient  $\Phi_i^z$  from equation (1.39) with no trend inflation under the baseline calibration.

Comparing Case 2 and Case 3 in Figure 1.6a highlights the effect of price stickiness heterogeneity on the coefficients  $\Phi_i^z$ .

Comparing Case 2 and Case 4 in Figure 1.6b highlights the effect of production networks on the coefficients  $\Phi_i^z$ . See Table 1.3 for a complete definition of each case.

Table 1.4: Correlation Coefficients-Characteristics

		Sectoral Coefficient					
		(a)	(b)	(c)	(d)	(e)	(f)
Economy	Key characteristic	$\Phi_i^p$	$ \Phi_i^p $	$\Phi_i^s$	$ \Phi_i^s $	$\Phi_i^z$	$ \Phi_i^z $
Case 3	Different stickiness, $\theta_i$	0.75	-0.75	-0.75	-0.75	0.75	-0.75
Case 4	Different centrality, $O_i$	0.99	-0.49	0.98	0.98	-0.98	0.98

Notes: The table reports the correlations between different sectoral coefficients and two characteristics highlighted by Cases 3 and 4: heterogeneity of price stickiness, measured as  $\theta_i$ , and heterogeneity of sectoral centrality, measured as the weighted out-degree  $O_i$ . In some cases the coefficients can take different signs, so the table also reports the correlation between the absolute value of the coefficient and the key characteristics. The coefficients are computed under no trend inflation. Details about Cases 3 and 4 are described in Table 1.3.

Table 1.5: Sectoral NKPC Coefficients with No Trend Inflation

Sector	$\Phi_i^p$	$\Phi_i^s$	$\Phi_i^z$	$\Phi_i^\pi$	$\Phi_i^\psi$
1. Agriculture	-0.23	0.10	-0.36	0.03	0.00
2. Metal mining	-0.27	0.09	-0.33	0.03	0.00
3. Coal mining	-0.01	0.01	-0.02	0.03	0.00
4. Oil and gas extraction	0.03	0.01	-0.04	0.03	0.00
5. Non-metallic mining	-0.02	0.01	-0.02	0.03	0.00
6. Construction	-0.02	0.01	-0.03	0.03	0.00
7. Food and kindred products	-0.02	0.02	-0.03	0.03	0.00
8. Tobacco	-0.02	0.01	-0.01	0.03	0.00
9. Textile mill products	-0.01	0.01	-0.01	0.03	0.00
10. Apparel	-0.01	0.00	-0.00	0.03	0.00
11. Lumber and wood	-0.02	0.01	-0.02	0.03	0.00
12. Furniture and fixtures	-0.01	0.00	-0.00	0.03	0.00
13. Paper and allied	-0.01	0.01	-0.01	0.03	0.00
14. Printing, publishing and allied	-0.00	0.00	-0.00	0.03	0.00
15. Chemicals	0.03	0.01	-0.02	0.03	0.00
16. Petroleum and coal products	-0.01	0.01	-0.04	0.03	0.00
17. Rubber and misc plastics	-0.00	0.00	-0.01	0.03	0.00
18. Leather	-0.01	0.00	-0.00	0.03	0.00
19. Stone, clay, glass	-0.00	0.00	-0.01	0.03	0.00
20. Primary metal	-0.03	0.03	-0.07	0.03	0.00
21. Fabricated metal	0.01	0.01	-0.01	0.03	0.00
22. Machinery, non-electrical	0.02	0.00	-0.01	0.03	0.00
23. Electrical machinery	-0.01	0.01	-0.01	0.03	0.00
24. Motor vehicles	-0.05	0.02	-0.06	0.03	0.00
25. Transportation equipment & ordnance	-0.01	0.00	-0.01	0.03	0.00
26. Instruments	-0.01	0.00	-0.00	0.03	0.00
27. Misc. manufacturing	-0.01	0.00	-0.00	0.03	0.00
28. Transportation	0.01	0.01	-0.03	0.03	0.00
29. Communications	-0.00	0.00	-0.01	0.03	0.00
30. Electric utilities	-0.01	0.01	-0.04	0.03	0.00
31. Gas utilities	-0.10	0.04	-0.14	0.03	0.00
32. Trade	0.00	0.02	-0.06	0.03	0.00
33. Finance Insurance and Real Estate	0.03	0.01	-0.03	0.03	0.00
34. Services	0.05	0.01	-0.01	0.03	0.00
Minimum	-0.27	0.00	-0.36	0.03	0.00
Maximum	0.05	0.10	-0.00	0.03	0.00
Mean	-0.02	0.01	-0.04	0.03	0.00
Sum	-0.60	0.49	-1.42	1.00	0.00

Notes: The table reports the calibrated parameters of the generalized NKPC in (1.39), under no trend inflation. Results

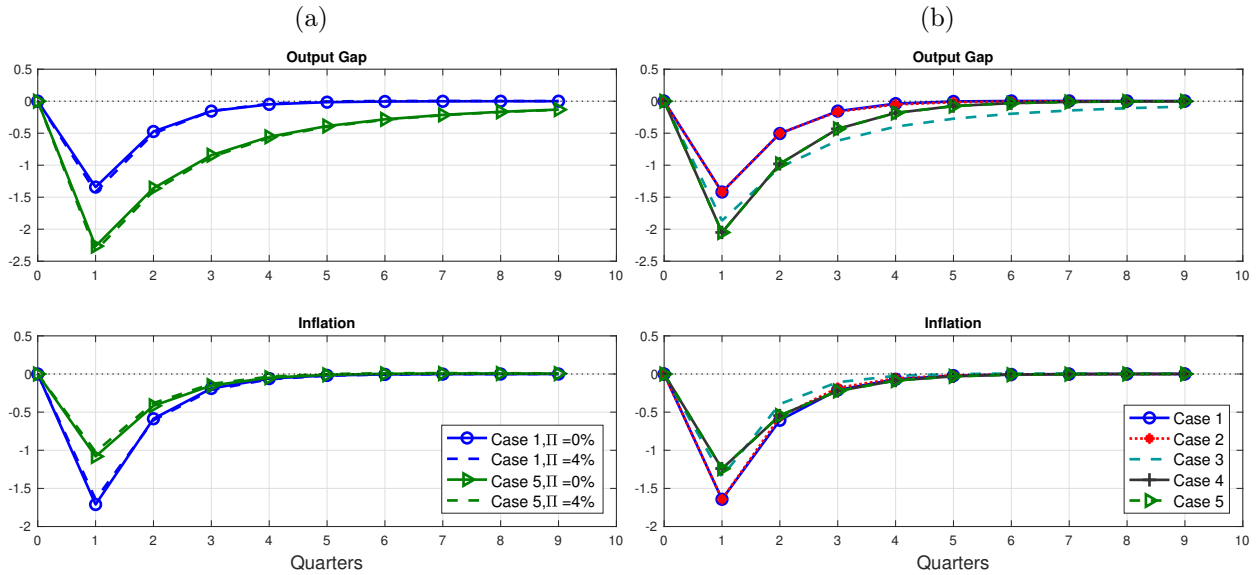
correspond to Case 5 described in Table 1.3.

Table 1.6: Sectoral NKPC Coefficients with Trend Inflation of 2%

Sector	$\Phi_i^p$	$\Phi_i^s$	$\Phi_i^z$	$\Phi_i^\pi$	$\Phi_i^\psi * 10^{-3}$
1. Agriculture	-0.21	0.10	-0.34	0.03	0.13
2. Metal mining	-0.25	0.08	-0.32	0.03	0.13
3. Coal mining	-0.01	0.01	-0.01	0.03	0.06
4. Oil and gas extraction	0.03	0.01	-0.04	0.03	0.08
5. Non-metallic mining	-0.02	0.01	-0.02	0.03	0.06
6. Construction	-0.02	0.01	-0.03	0.03	0.08
7. Food and kindred products	-0.01	0.02	-0.03	0.03	0.06
8. Tobacco	-0.02	0.01	-0.01	0.03	0.04
9. Textile mill products	-0.01	0.01	-0.01	0.03	0.04
10. Apparel	-0.00	0.00	-0.00	0.03	0.01
11. Lumber and wood	-0.01	0.01	-0.02	0.03	0.06
12. Furniture and fixtures	-0.00	0.00	-0.00	0.03	0.02
13. Paper and allied	-0.00	0.01	-0.01	0.03	0.05
14. Printing, publishing and allied	-0.00	0.00	-0.00	0.03	0.01
15. Chemicals	0.03	0.01	-0.02	0.03	0.06
16. Petroleum and coal products	-0.01	0.01	-0.03	0.03	0.08
17. Rubber and misc plastics	0.00	0.00	-0.01	0.03	0.04
18. Leather	-0.00	0.00	-0.00	0.03	0.01
19. Stone, clay, glass	-0.00	0.00	-0.01	0.03	0.04
20. Primary metal	-0.03	0.03	-0.07	0.03	0.10
21. Fabricated metal	0.01	0.01	-0.01	0.03	0.03
22. Machinery, non-electrical	0.02	0.00	-0.01	0.03	0.02
23. Electrical machinery	0.00	0.00	-0.01	0.03	0.04
24. Motor vehicles	-0.04	0.02	-0.05	0.03	0.10
25. Transportation equipment & ordnance	-0.01	0.00	-0.01	0.03	0.04
26. Instruments	-0.00	0.00	-0.00	0.03	0.01
27. Misc. manufacturing	-0.00	0.00	-0.00	0.03	0.02
28. Transportation	0.01	0.01	-0.03	0.03	0.08
29. Communications	-0.00	0.00	-0.01	0.03	0.04
30. Electric utilities	-0.00	0.01	-0.03	0.03	0.08
31. Gas utilities	-0.09	0.04	-0.14	0.03	0.12
32. Trade	0.00	0.02	-0.05	0.03	0.09
33. Finance Insurance and Real Estate	0.03	0.01	-0.02	0.03	0.07
34. Services	0.05	0.01	-0.01	0.03	0.02
Minimum	-0.25	0.00	-0.34	0.03	0.01
Maximum	0.05	0.10	-0.00	0.03	0.13
Mean	-0.02	0.01	-0.04	0.03	0.06
Sum	-0.57	0.46	-1.34	1.01	1.92

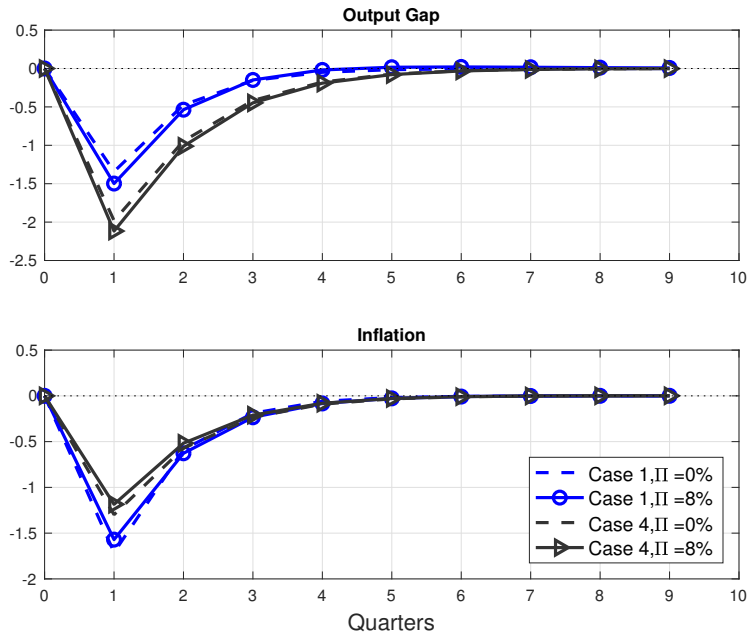
Notes: The table reports the calibrated parameters of the generalized NKPC in (1.39), under trend inflation equal to 2% annually. Results correspond to Case 5 described in Table 1.3.

Figure 1.7: Impulse Response Functions to a 1% Monetary Shock



Notes: Figure 1.7a depicts the annualized IRF to a 1% monetary shock for Cases 1 and 4 under the baseline calibration and two different levels of trend inflation. Figure 1.7b shows the annualized IRF to a 1% monetary shock for all cases described in Table 1.3 under the baseline calibration and trend inflation equal to 4%.

Figure 1.8: Impulse Response Functions to a 1% Monetary Shock, All Cases



Notes: The figure depicts the annualized IRF to a 1% monetary shock under the baseline calibration and 2 levels of trend inflation. Cases 1 to 4 are described in Table 1.3.

Table 1.7: Cumulative response to a 1% monetary shock, baseline calibration

(a) Output gap

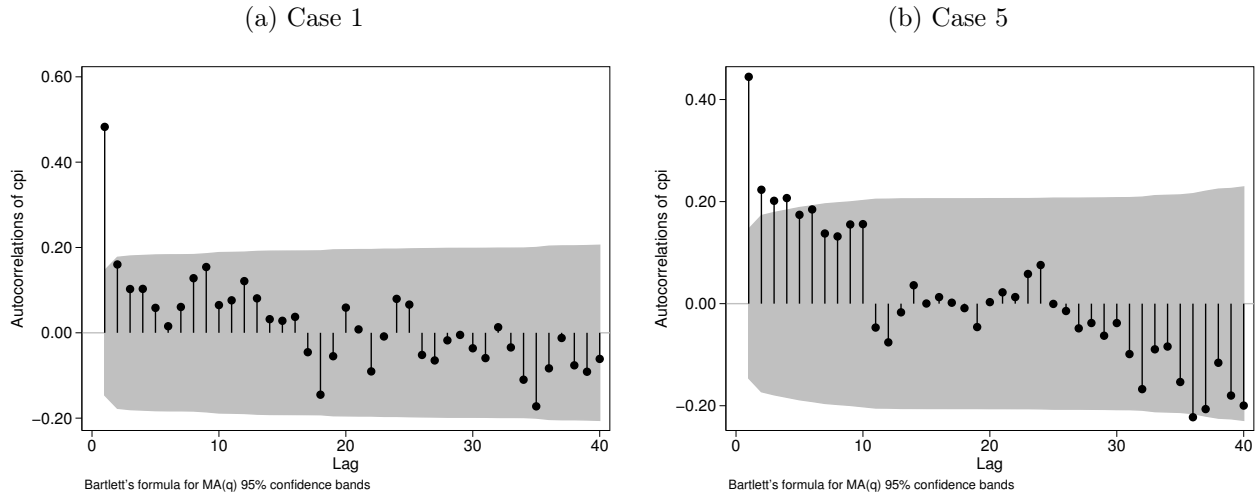
Case	At impact					At 4th quarter				
	Inflation Trend					Inflation Trend				
	0%	2%	4%	6%	8%	0%	2%	4%	6%	8%
1	-0.34	-0.35	-0.35	-0.36	-0.37	-0.50	-0.52	-0.53	-0.54	-0.55
2	-0.34	-0.35	-0.35	-0.36	-0.37	-0.50	-0.52	-0.53	-0.55	-0.56
3	-0.43	-0.45	-0.47	–	–	-0.90	-0.94	-0.98	–	–
4	-0.50	-0.50	-0.51	-0.52	-0.53	-0.88	-0.90	-0.91	-0.93	-0.94
5	-0.57	-0.58	-0.58	–	–	-1.26	-1.28	-1.30	–	–

Case	At impact					At 4th quarter				
	Inflation Trend					Inflation Trend				
	0%	2%	4%	6%	8%	0%	2%	4%	6%	8%
1	-0.43	-0.42	-0.41	-0.40	-0.39	-0.64	-0.63	-0.63	-0.63	-0.63
2	-0.43	-0.42	-0.41	-0.40	-0.39	-0.64	-0.62	-0.61	-0.60	-0.58
3	-0.36	-0.35	-0.34	–	–	-0.52	-0.49	-0.47	–	–
4	-0.32	-0.32	-0.31	-0.30	-0.30	-0.55	-0.54	-0.52	-0.51	-0.50
5	-0.27	-0.26	-0.26	–	–	-0.42	-0.41	-0.39	–	–

(b) Inflation gap

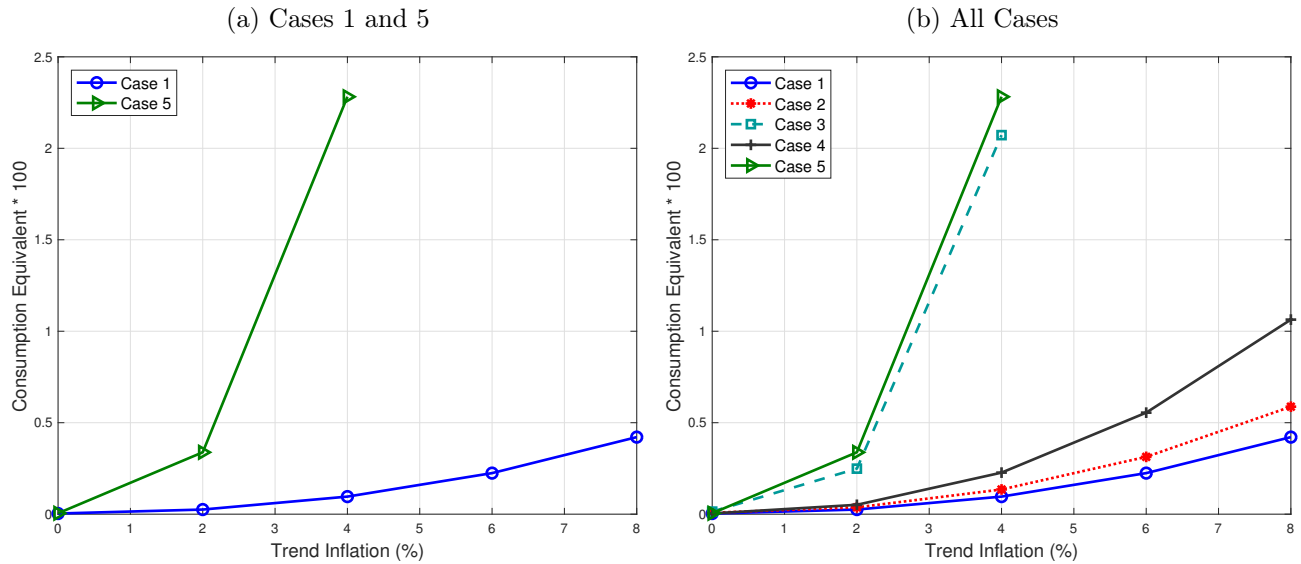
Notes: The tables report the cumulative annualized response of the output gap and inflation gap to a 1% monetary shock under the baseline calibration for different levels of trend inflation and for the 5 cases described in Table 1.3. In Cases 3 and 5, a unique equilibrium does not exist for trend inflation above 4%, so the values are not reported. The output gap is defined as the log-difference between aggregate value-added output relative to its steady state level. The inflation gap is defined as the log-difference between gross aggregate inflation and its steady state level.

Figure 1.9: Inflation Autocorrelation



Notes: The figure depicts the autocorrelation coefficients of aggregate inflation for Cases 1 and 5 described in Table 1.3. The autocorrelations are computed by solving each model and performing a Montecarlo simulation with monetary and productivity shocks. See Section 1.7 for details about the simulation.

Figure 1.10: Consumption Equivalent

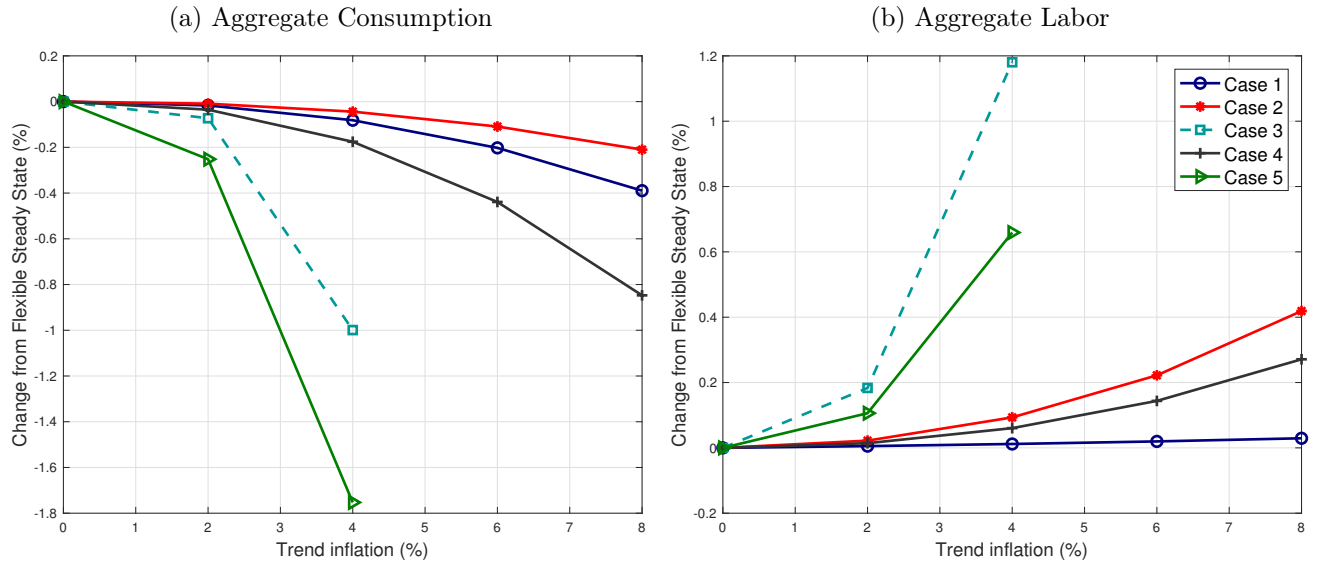


Notes: For each level of trend inflation the figures show welfare costs measured as the consumption equivalent implicitly defined by equation (1.42). See Table 1.3 for the definition of Cases 1 to 5. For trend inflation above 4% a unique equilibrium does not exist for Cases 3 and 5.

Table 1.8: Consumption Equivalent

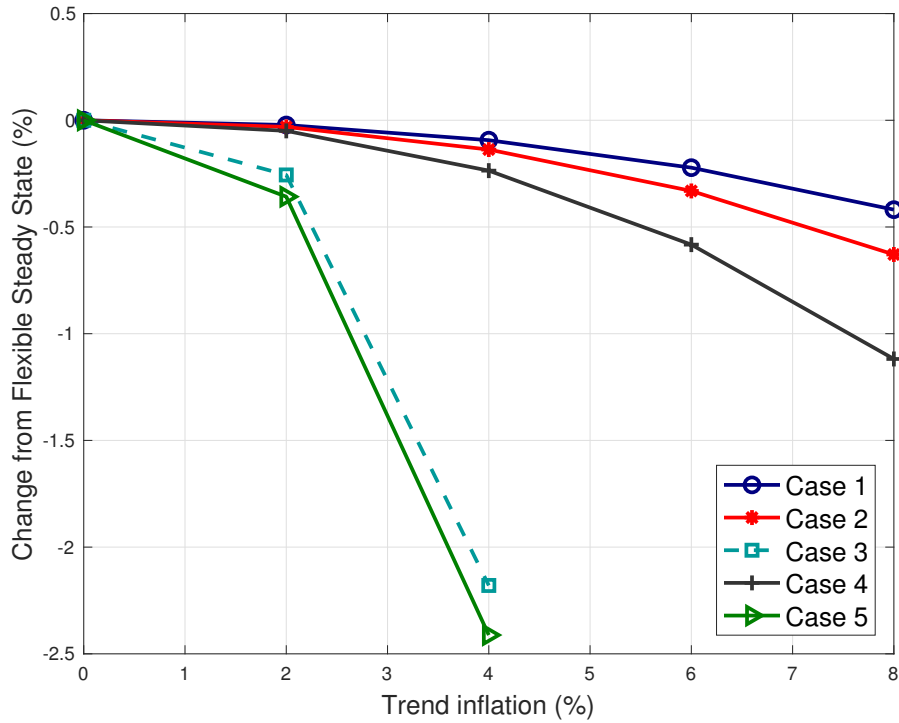
(a) Baseline Calibration						(b) Share of intermediate inputs = 0.65					
Case	Trend Inflation					Case	Trend Inflation				
	0%	2%	4%	6%	8%		0%	2%	4%	6%	8%
1	0.00	0.03	0.10	0.22	0.42	1	0.00	0.03	0.10	0.22	0.42
2	0.01	0.04	0.14	0.31	0.59	2	0.01	0.04	0.14	0.31	0.59
3	0.01	0.25	2.07	-	-	3	0.01	0.25	2.07	-	-
4	0.00	0.05	0.23	0.55	1.06	4	0.00	0.05	0.27	0.66	1.28
5	0.00	0.34	2.28	-	-	5	0.00	0.38	2.68	-	-
(c) Only Sectoral Shocks						(d) Higher elasticity of substitution, $\epsilon = 10$					
Case	Trend Inflation					Case	Trend Inflation				
	0%	2%	4%	6%	8%		0%	2%	4%	6%	8%
1	0.00	0.03	0.10	0.22	0.42	1	0.01	0.04	0.15	0.36	0.71
2	0.01	0.04	0.14	0.31	0.59	2	0.01	0.05	0.21	0.51	1.02
3	0.02	0.25	2.07	-	-	3	0.02	0.44	-	-	-
4	0.01	0.05	0.23	0.56	1.07	4	0.01	0.08	0.37	0.93	1.86
5	0.01	0.34	2.28	-	-	5	0.01	0.64	-	-	-

Figure 1.11: Steady State Values



Notes: For each level of trend inflation the figures show the difference between the steady state level of a variable in the sticky price equilibrium relative to the flexible price equilibrium. The definition of Cases 1 to 5 is detailed in Table 1.3.

Figure 1.12: Steady State TFP



Notes: For each level of trend inflation the figure shows the difference between steady state TFP in the sticky price equilibrium relative to the flexible price equilibrium. The definition of Cases 1 to 5 is detailed in Table 1.3.

Table 1.9: Annualized Standard Deviations

(a) Aggregate Consumption

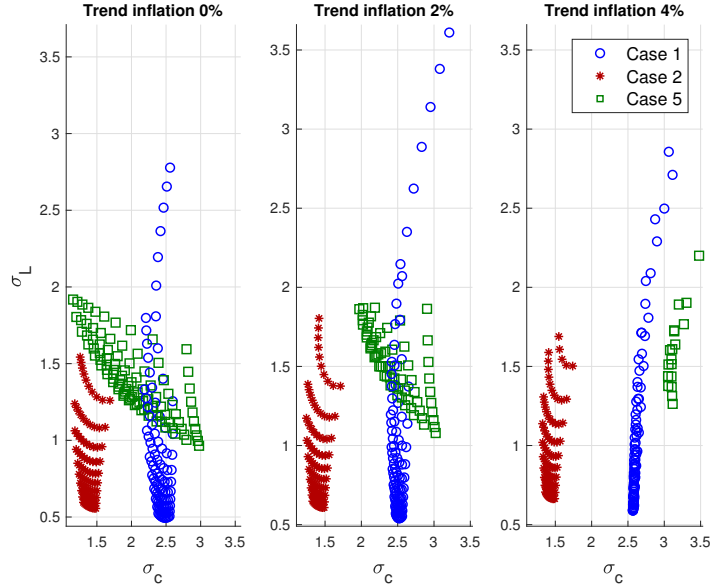
Case	Trend Inflation				
	0%	2%	4%	6%	8%
1.	2.54	2.57	2.60	2.64	2.69
2.	1.49	1.50	1.52	1.53	1.55
3.	1.57	1.62	1.70	–	–
4.	2.78	2.81	2.85	2.89	2.96
5.	2.68	2.77	3.13	–	–

Case	Trend Inflation				
	0%	2%	4%	6%	8%
1.	0.71	0.77	0.84	0.92	1.01
2.	0.77	0.84	0.91	0.99	1.09
3.	1.15	1.31	1.56	–	–
4.	0.93	1.01	1.09	1.18	1.28
5.	1.20	1.37	1.74	–	–

(b) Aggregate Labor

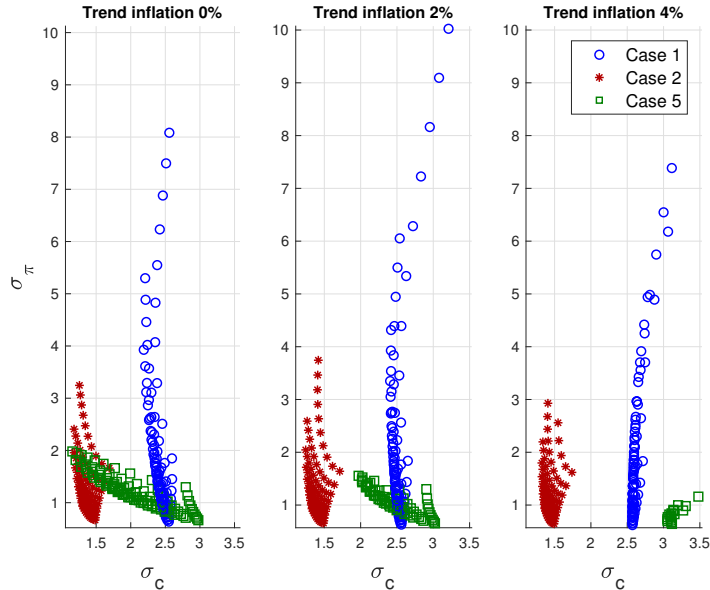
Notes: For each case described in Table 1.3, these tables report the annualized standard deviations of consumption and labor under different values of trend inflation.

Figure 1.13: Feasible  $(\sigma_C, \sigma_L)$  Frontiers



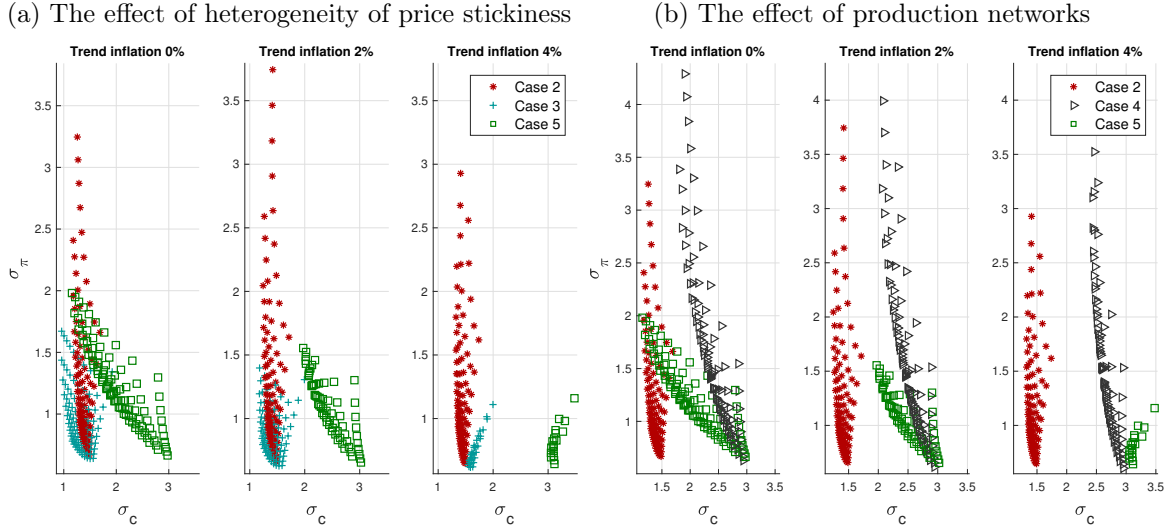
Notes: The figure displays pairs of annualized standard deviations  $(\sigma_C, \sigma_L)$  for different combinations of policy parameters  $(\phi_c, \phi_\pi)$  of the Taylor rule. The parameter  $\phi_\pi$  takes values in  $[1.1, 3]$  while  $\phi_c$  takes values in  $[0.05, 1]$ . For each combination of parameters the solution of the model is computed and a Montecarlo simulation is performed to calculate the variances of labor and consumption. The definition of Cases 1, 2 and 5 is detailed in Table 1.3.

Figure 1.14: Feasible  $(\sigma_C, \sigma_\pi)$  Frontiers



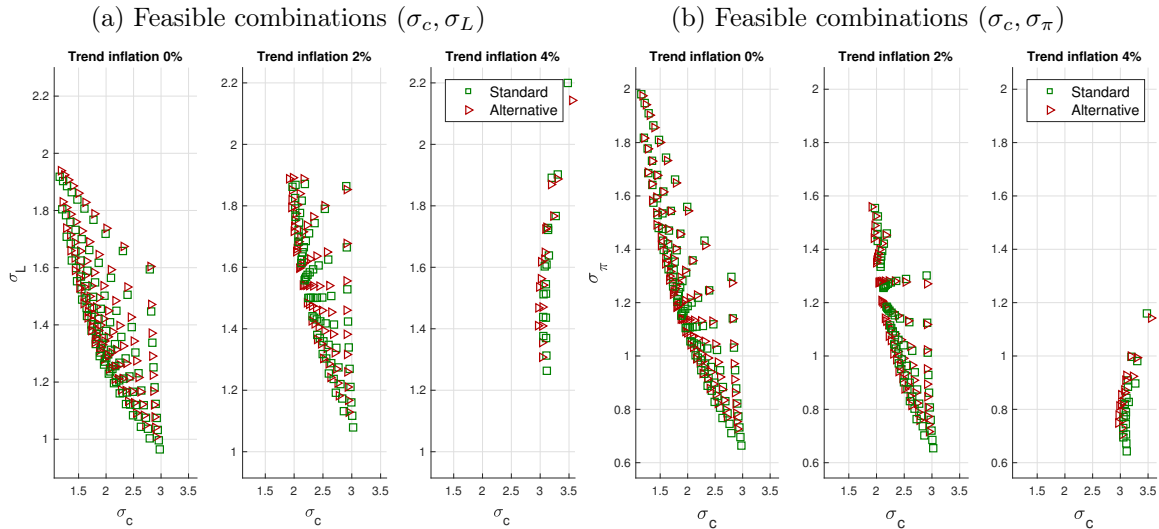
Notes: The figure displays pairs of annualized standard deviations  $(\sigma_C, \sigma_\pi)$  for different combinations of policy parameters  $(\phi_c, \phi_\pi)$  of the Taylor rule. The parameter  $\phi_\pi$  takes values in  $[1.1, 3]$  while  $\phi_c$  takes values in  $[0.05, 1]$ . For each combination of parameters the solution of the model is computed and a Montecarlo simulation is performed to calculate the variances of consumption and inflation. The definition of Cases 1, 2 and 5 is detailed in Table 1.3.

Figure 1.15: Feasible  $(\sigma_C, \sigma_\pi)$  Frontiers



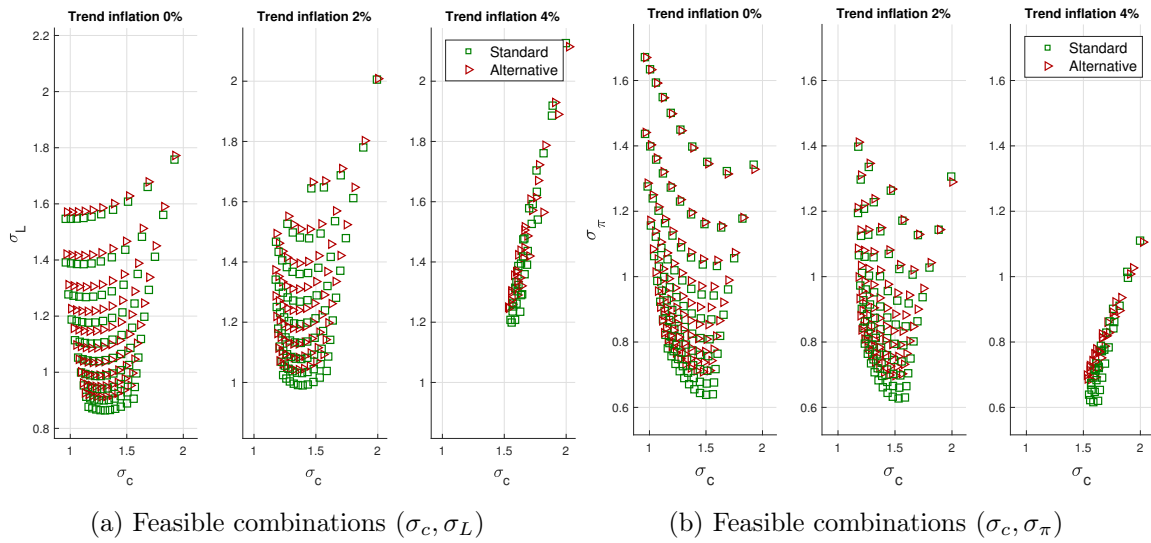
Notes: The figure displays pairs of annualized standard deviations  $(\sigma_C, \sigma_\pi)$  for different combinations of policy parameters  $(\phi_C, \phi_\pi)$  of the Taylor rule. The parameter  $\phi_\pi$  takes values in  $[1.1, 3]$  while  $\phi_C$  takes values in  $[0.05, 1]$ . For each combination of parameters the solution of the model is computed and a Montecarlo simulation is performed to calculate the variances of consumption and inflation. The definition of Cases 1, 2 and 5 is detailed in Table 1.3.

Figure 1.16: Alternative Taylor Rules, Sectors Weighted by Stickiness



Notes: The figure displays pairs of annualized standard deviations  $(\sigma_C, \sigma_\pi)$  for different combinations of policy parameters  $(\phi_C, \phi_\pi)$  of the Taylor rule. The parameter  $\phi_\pi$  takes values in  $[1.1, 3]$  while  $\phi_C$  takes values in  $[0.05, 1]$ . The Standard case corresponds to the standard Taylor rule. The Alternative case uses sectoral weights defined as  $\alpha_i^{alt} = \theta_i / \sum_{i'=1}^N \theta_{i'}$ . See section 1.7.2 for details. For each combination of parameters the solution of the model is computed and a Montecarlo simulation is performed to calculate the variances of consumption and inflation. The results are reported for case 5 described in Table 1.3.

Figure 1.17: Alternative Taylor Rules, Sectors Weighted by Stickiness and Centrality



Notes: The figure displays pairs of annualized standard deviations  $(\sigma_c, \sigma_\pi)$  for different combinations of policy parameters  $(\phi_c, \phi_\pi)$  of the Taylor rule. The parameter  $\phi_\pi$  takes values in  $[1.1, 3]$  while  $\phi_c$  takes values in  $[0.05, 1]$ . The Standard case corresponds to the standard Taylor rule. The Alternative case uses sectoral weights defined as  $\alpha_i^{alt} = \theta_i O_i / \sum_{i'=1}^N (\theta_{i'} O_{i'})$ . See section 1.7.2 for details. For each combination of parameters the solution of the model is computed and a Montecarlo simulation is performed to calculate the variances of consumption and inflation. The results are reported for case 5 described in Table 1.3.

## 1.A Appendix to Section 1.3

### 1.A.1 Firms

The marginal cost

The total cost of producing quantity  $Y_{(i,j),t}$  is given by

$$C\left(Y_{(i,j),t}\right) = \min_{L_{(i,j),t}, \{X_{(i,j),(i',j'),t}\}} W_{i,t} L_{(i,j),t} + \sum_{i'=1}^N \int_0^1 X_{(i,j),(i',j'),t} P_{(i',j'),t} dj'$$

subject to the production function (1.9) and the CES aggregator (1.11). The CES structure of the sectoral bundles allows to simplify the latter problem and write it in terms of just sectoral variables conditional on some optimality conditions. Given a certain level for the sectoral bundle from a sector  $i'$ ,  $X_{(i,j),i'}$ , a firm  $(i, j)$  faces the following cost minimization problem

$$\begin{aligned} \min_{\{X_{(i,j),(i',j'),t}\}} & \int_0^1 X_{(i,j),(i',j'),t} P_{(i',j'),t} dj' \\ \text{s.t.} & \\ X_{(i,j),i',t} & = \left( \int_0^1 X_{(i,j),(i',j'),t}^{\frac{\epsilon-1}{\epsilon}} P_{(i',j'),t} dj' \right)^{\frac{\epsilon}{\epsilon-1}}. \end{aligned} \quad (1.46)$$

The solution to this problem gives the demand of firm  $(i, j)$  for intermediate goods produced by firm  $(i', j')$  conditional on  $(i, j)$ 's demand of the sectoral bundle  $X_{(i,j),i',t}$ ,

$$X_{(i,j),(i',j')} = \left( \frac{P_{(i',j'),t}}{P_{i',t}} \right)^{-\epsilon} X_{(i,j),i',t}, \quad (1.47)$$

where the sectoral price index is defined by  $P_{i',t} = \left( \int_0^1 P_{(i',j'),t}^{1-\epsilon} dj' \right)^{\frac{1}{1-\epsilon}}$ . Given this optimality condition, the problem of cost minimization can be written in terms of sectoral

variables:

$$\mathcal{C}\left(Y_{(i,j),t}\right) = \min_{L_{(i,j),t}, \{X_{(i,j),i',t}\}} W_{i,t}L_{(i,j),t} + \sum_{i'=1}^N X_{(i,j),i',t}P_{i',t}dj'$$

subject to the production function (1.9).

Given a quantity of output  $Y_{(i,j),t}$ , optimality implies the following conditional demands for inputs

$$L_{(i,j),t} = \delta \frac{MC_{i,t}}{W_{i,t}} Y_{(i,j),t}, \quad (1.48)$$

$$X_{(i,j),i',t} = \omega_{i,i'} \frac{MC_{i,t}}{P_{i',t}} Y_{(i,j),t}, \quad (1.49)$$

where  $MC_{i,t}$  is the nominal marginal cost of production in industry  $i$ , given by

$$MC_{i,t} = \frac{P_{i,t}^m \left(\frac{W_{i,t}}{\delta}\right)^\delta}{Z_{i,t}^p}, \quad (1.50)$$

and where  $P_{i,t}^m$  is the industry specific price index of materials, defined by

$$P_{i,t}^m = \prod_{i'=1}^N \left(\frac{P_{i',t}}{\omega_{i,i'}}\right)^{\omega_{i,i'}}.$$

Note that the marginal cost is the same for every firm within sector  $i$ , independently of the price charged. This is an implication of the CRS assumption. Also, this assumption implies that the total cost of production is simply

$$\mathcal{C}\left(Y_{(i,j),t}\right) = MC_{i,t}Y_{(i,j),t}. \quad (1.51)$$

Firm's total demand

Since a firm  $(i, j)$  sells its output as a consumption good to the representative household and as an intermediate good to all the firms from (possibly) all sector of the economy, its total demand is given by

$$Y_{(i,j),t} = C_{(i,j),t} + \sum_{i'=1}^N \int_0^1 X_{(i',j'),(i,j),t} dj'.$$

Given the CES structure of both the consumption and production bundle then  $C_{(i,j),t} = \left(\frac{P_{(i,j),t}}{P_{i,t}}\right)^{-\epsilon} C_{i,t}$  and  $X_{(i',j'),(i,j),t} = \left(\frac{P_{(i,j),t}}{P_{i,t}}\right)^{-\epsilon} X_{i',i,t}$ . As a result we can replace these expression into the total demand of firm  $(i, j)$  to get

$$Y_{(i,j),t} = \left(\frac{P_{(i,j),t}}{P_{i,t}}\right)^{-\epsilon} \left[ C_{i,t} + \sum_{i'=1}^N X_{i',i,t} \right].$$

where  $X_{i',i,t} := \int_0^1 X_{(i',j'),i,t} dj'$  is the total demand of sector  $i'$  for inputs from sector  $i$ . Defining  $Y_{i,t} := C_{i,t} + \sum_{i'=1}^N X_{i',i,t}$  yields equation (1.17).

Optimal pricing condition

The solution to the price-setting problem (1.19) is

$$p_{i,t}^* = \frac{\epsilon}{\epsilon - 1} \frac{\mathbb{E}_t \sum_{k=0}^{\infty} \theta^k \Lambda_{t,t+k} \Pi_{i,t,t+k}^\epsilon Y_{i,t+k} mc_{i,t+k}}{\mathbb{E}_t \sum_{k=0}^{\infty} \theta^k \Lambda_{t,t+k} \frac{\Pi_{i,t,t+k}^\epsilon}{\Pi_{t,t+k}} Y_{i,t+k}}, \quad (1.52)$$

where  $\Pi_{i,t,t+k} := \frac{P_{i,t+k}}{P_{i,t}}$  is gross sectoral inflation between periods  $t$  and  $t+k$  in industry  $i$ ,  $mc_{i,t+k} := MC_{i,t+k}/P_{t+k}$  is the real marginal cost in this industry and  $\Pi_{t,t+k}$  is aggregate gross inflation. The optimal pricing condition (1.52) can be written in terms of the auxiliary

variables  $\psi_{i,t}$  and  $\Delta_{i,t}$  as

$$p_{i,t}^* = \frac{\epsilon}{\epsilon - 1} \frac{\psi_{i,t}}{\Delta_{i,t}} \quad (1.53)$$

where

$$\psi_{i,t} := \mathbb{E}_t \sum_{k=0}^{\infty} \Lambda_{t,t+k} \theta^k \Pi_{i,t,t+k}^\epsilon Y_{i,t+k} m c_{i,t+k}$$

and

$$\Delta_{i,t} := \mathbb{E}_t \sum_{k=0}^{\infty} \Lambda_{t,t+k} \theta^k \frac{\Pi_{i,t,t+k}^\epsilon}{\Pi_{t,t+k}} Y_{i,t+k}.$$

We can use the recursive structure of  $\psi_{i,t}$  and  $\Delta_{i,t}$  to write these terms as

$$\psi_{i,t} = Y_{i,t} C_t^{-\sigma} m c_{i,t} + \theta_i \beta \mathbb{E}_t \left[ \Pi_{i,t+1}^\epsilon \psi_{i,t+1} \right], \quad (1.54)$$

$$\Delta_{i,t} = Y_{i,t} C_t^{-\sigma} + \theta_i \beta \mathbb{E}_t \left[ \frac{\Pi_{i,t+1}^\epsilon}{\Pi_{t+1}} \Delta_{i,t+1} \right], \quad (1.55)$$

where  $\Pi_{i,t+1}$  and  $\Pi_{t+1}$  denote gross sectoral and aggregate inflation between periods  $t$  and  $t + 1$ , respectively.

Given the time-dependent structure of prices, at each moment of time there is a measure  $1 - \theta_i$  of firms re-optimizing their price and a measure  $\theta_i$  keeping their price from the previous period. Thus the sectoral price satisfies

$$\begin{aligned} P_{i,t} &= \left( \theta_i P_{i,t-1}^{1-\epsilon} + (1 - \theta_i) \left( P_{i,t}^* \right)^{1-\epsilon} \right)^{\frac{1}{1-\epsilon}} \\ 1 &= \left( \theta_i \left( \frac{P_{i,t-1}}{P_{i,t}} \right)^{1-\epsilon} + (1 - \theta_i) \left( \frac{P_{i,t}^*}{P_t} \frac{P_t}{P_{i,t}} \right)^{1-\epsilon} \right)^{\frac{1}{1-\epsilon}} \\ \Rightarrow P_{i,t}^* &= \left( \frac{1 - \theta_i \Pi_{i,t}^{\epsilon-1}}{1 - \theta_i} \right)^{\frac{1}{1-\epsilon}} P_{i,t}. \end{aligned} \quad (1.56)$$

Where lowercase letters denote prices relative to the aggregate price index.

On the other hand, we can get rid of  $\Delta_{i,t}$  by combining equations (1.56) and (1.20). These equations imply

$$\Delta_{i,t} = \frac{\epsilon}{\epsilon - 1} \left( \frac{1 - \theta_i \Pi_{i,t}^{\epsilon-1}}{1 - \theta_i} \right)^{\frac{1}{\epsilon-1}} \frac{1}{p_{i,t}} \psi_{i,t},$$

using this expression back in (1.55) we get equation (1.22) from the text.

## 1.B Appendix to section 1.4

### 1.B.1 Equilibrium system

The equilibrium is defined by the system of equations below. Equations (1.57) to (1.60) are necessary for every sector  $i = 1, \dots, N$ , where  $mc_{i,t}$  is determined by (1.26) conditional on the other endogenous variables. Equation (1.61) is a definition needed to keep track of the evolution of the relative prices given the inflation rates. The Euler equation (1.62) and the Taylor equation (1.63) are the aggregate equations needed to close the model. Together, the system defines  $5N + 2$  equations determining  $5N$  sectoral endogenous variables,  $\{\psi_{i,t}, s_{i,t}, \Pi_{i,t}, p_{i,t}, Y_{i,t}\}_{i=1}^N$ , plus value-added output, i.e.  $C_t$ , and the nominal

interest rate,  $I_t$ .

$$\psi_{i,t} = Y_{i,t} C_t^{-\sigma} m c_{i,t} + \theta_i \beta \mathbb{E}_t \left[ \Pi_{i,t+1}^\epsilon \psi_{i,t+1} \right], \quad (1.57)$$

$$\left( \frac{1 - \theta_i \Pi_{i,t}^{\epsilon-1}}{1 - \theta_i} \right)^{\frac{1}{\epsilon-1}} \psi_{i,t} = \frac{\epsilon - 1}{\epsilon} Y_{i,t} C_t^{-\sigma} p_{i,t} + \theta_i \beta \mathbb{E}_t \left[ \Pi_{i,t+1}^{\epsilon-1} \left( \frac{1 - \theta_i \Pi_{i,t+1}^{\epsilon-1}}{1 - \theta_i} \right)^{\frac{1}{\epsilon-1}} \psi_{i,t+1} \right] \quad (1.58)$$

$$s_{i,t} = (1 - \theta_i) \left( \frac{1 - \theta_i \Pi_{i,t}^{\epsilon-1}}{1 - \theta_i} \right)^{\frac{\epsilon}{\epsilon-1}} + \theta_i \Pi_{i,t}^\epsilon s_{i,t-1}, \quad (1.59)$$

$$Y_{i,t} = \alpha_i \frac{C_t}{p_{i,t}} + \sum_{i'=1}^N \omega_{i',i} \frac{m c_{i',t}}{p_{i,t}} s_{i',t} Y_{i',t}, \quad (1.60)$$

$$p_{i,t} = p_{i,t-1} \frac{\Pi_{i,t}}{\Pi_t}, \quad (1.61)$$

$$1 = \mathbb{E}_t \left[ \beta \left( \frac{C_{t+1}}{C_t} \right)^{-\sigma} \frac{I_t}{\Pi_{t+1}} \right], \quad (1.62)$$

$$\frac{I_t}{\bar{I}} = \left( \frac{I_t}{\bar{I}} \right)^{\rho_I} \left[ \left( \frac{C_t}{\bar{C}} \right)^{\phi_c} \left( \frac{\Pi_t}{\bar{\Pi}} \right)^{\phi_\pi} \right]^{1-\rho_I} Z_t^m. \quad (1.63)$$

### 1.B.2 Log-linearized Equilibrium System

The online appendix shows how a log-linearization of the model around a positive inflation steady-state equilibrium is characterized by the following system of equations,

$$0 = \mathbb{E}_t [\hat{C}_{t+1}] + \frac{1}{\sigma} \left( \mathbb{E}_t [\hat{\Pi}_{t+1}] - \hat{I}_t \right) - \hat{C}_t \quad (1.64)$$

$$0 = \rho_I \hat{I}_{t-1} + (1 - \rho_I) \left( \phi_c \hat{C}_t + \phi_\pi \hat{\Pi}_t \right) + z_t^m - \hat{I}_t \quad (1.65)$$

$$\mathbf{0} = \text{diag} \left( \bar{\Pi}_i^\epsilon \theta_i \right) \hat{\mathbf{s}}_{t-1} + \text{diag} \left( \frac{\bar{\Pi}_i^{\epsilon-1} \theta_i \epsilon}{1 - \bar{\Pi}_i^{\epsilon-1} \theta_i} \right) \hat{\mathbf{\Pi}}_t - \hat{\mathbf{s}}_t \quad (1.66)$$

$$\begin{aligned} \mathbf{0} = & (\mathbf{1}\sigma - \mathbb{Y}_c) \hat{C}_t - \text{diag} \left( \frac{\theta_i}{(1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (1 - \theta_i \beta \bar{\Pi}_i^{\epsilon-1})} \bar{\Pi}_i^{\epsilon-1} \right) \hat{\mathbf{\Pi}}_t - (\mathbf{I} + \mathbb{Y}_p) \hat{\mathbf{p}}_t - \mathbb{Y}_s \hat{\mathbf{s}}_t + \text{diag} \left( \frac{1}{(1 - \theta_i \beta \bar{\Pi}_i^{\epsilon-1})} \right) \hat{\boldsymbol{\psi}}_t - \mathbb{Y}_z \hat{\mathbf{z}}_t^p \\ & - \text{diag} \left( \frac{\theta_i \beta \bar{\Pi}_i^{\epsilon-1} \left( \epsilon - 1 - \frac{\theta_i \bar{\Pi}_i^{\epsilon-1}}{1 - \theta_i \bar{\Pi}_i^{\epsilon-1}} \right)}{(1 - \theta_i \beta \bar{\Pi}_i^{\epsilon-1})} \right) \mathbb{E}_t [\hat{\mathbf{\Pi}}_{t+1}] - \text{diag} \left( \frac{\theta_i \beta \bar{\Pi}_i^{\epsilon-1}}{(1 - \theta_i \beta \bar{\Pi}_i^{\epsilon-1})} \right) \mathbb{E}_t [\hat{\boldsymbol{\psi}}_{t+1}] \end{aligned} \quad (1.67)$$

$$\begin{aligned} \mathbf{0} = & \frac{1 + \varphi}{1 + (1 - \delta) \varphi} (\mathbb{Y}_c - (1 - \delta) \boldsymbol{\sigma} \mathbf{1}) \hat{C}_t + \frac{1 + \varphi}{1 + (1 - \delta) \varphi} (\boldsymbol{\Omega} + \mathbb{Y}_p) \hat{\mathbf{p}}_t + \frac{1}{1 + (1 - \delta) \varphi} ((1 + \varphi) \mathbb{Y}_s + \delta \varphi \mathbf{I}) \hat{\mathbf{s}}_t - \text{diag} \left( \frac{1}{1 - \theta_i \beta \bar{\Pi}_i^\epsilon} \right) \hat{\boldsymbol{\psi}}_t \\ & + \frac{1 + \varphi}{1 + (1 - \delta) \varphi} (\mathbb{Y}_z - \mathbf{I}) \hat{\mathbf{z}}_t^p + \text{diag} \left( \frac{\theta_i \beta \epsilon \bar{\Pi}_i^\epsilon}{(1 - \theta_i \beta \bar{\Pi}_i^\epsilon)} \right) \mathbb{E}_t [\hat{\mathbf{\Pi}}_{t+1}] + \text{diag} \left( \frac{\theta_i \beta \bar{\Pi}_i^\epsilon}{1 - \theta_i \beta \bar{\Pi}_i^\epsilon} \right) \mathbb{E}_t [\hat{\boldsymbol{\psi}}_{t+1}] \end{aligned} \quad (1.68)$$

$$\mathbf{0} = \hat{\mathbf{p}}_{t-1} + (\mathbf{I} - \mathbf{1}\boldsymbol{\alpha}') \hat{\mathbf{\Pi}}_t - \hat{\mathbf{p}}_t. \quad (1.69)$$

Where bold letters of signs denote vectors,  $\text{diag}(a_i)$  denotes a  $N \times N$  diagonal matrix with elements  $a_i$  in the  $i$ -th diagonal,  $\mathbb{Y}_c$  is a  $N \times 1$  vector and  $\mathbb{Y}_s, \mathbb{Y}_p, \mathbb{Y}_z$  are  $N \times N$  matrices determined in steady state.

### 1.B.3 Aggregate Production Function

Domar weights

We can manipulate the sectoral market clearing condition for goods (1.60) to get the following equation for determining the Domar weights,

$$\eta_{i,t} = \alpha_i + \sum_{i'=1}^N \omega_{i',i} \frac{mc_{i',t} s_{i',t}}{p_{i',t}} \eta_{i',t},$$

where  $\eta_{i,t} := \frac{Y_{i,t} p_{i,t}}{C_t}$ . By redefining  $\tilde{\omega}_{i,i',t} = \omega_{i,i'} \frac{m c_{i,t} s_{i,t}}{p_{i,t}}$  the Domar weights can be determined as a function of other variables,

$$\boldsymbol{\eta}_t = \left( \mathbf{I} - \tilde{\boldsymbol{\Omega}}_t' \right)^{-1} \boldsymbol{\alpha}. \quad (1.70)$$

On the other hand, inputs hired by an individual firm can be written in terms of total inputs hired by that firm's sector by computing the ratio  $\kappa_{(i,j),t} := L_{(i,j),t}/L_{i,t}$ . Using the individual labor demand (1.14) we get the ratio is equal to  $\kappa_{(i,j),t} = \left( \frac{P_{i,t}}{P_{(i,j),t}} \right)^\epsilon s_{i,t}^{-1}$ . The structure of the problem implies the same ratio for intermediate inputs from other industries, i.e.  $\kappa_{(i,j),t} = X_{(i,j),i',t}/X_{i,i',t} = \left( \frac{P_{i,t}}{P_{(i,j),t}} \right)^\epsilon s_{i,t}^{-1}$ . Using this result, sectoral production can be written in terms of sectoral inputs utilized by firms within that sector,

$$\begin{aligned} Y_{i,t} &= \int_0^1 Z_{i,t}^p \left( \kappa_{(i,j),t} L_{i,t} \right)^\delta \prod_{i'=1}^N \left( \kappa_{(i,j),t} X_{i,i',t} \right)^{\omega_{i,i'}} dj \\ &= Z_{i,t}^p L_{i,t}^\delta \prod_{i'=1}^N X_{i,i',t}^{\omega_{i,i'}} \int_0^1 \kappa_{(i,j),t} dj \\ &= Z_{i,t}^p L_{i,t}^\delta \prod_{i'=1}^N X_{i,i',t}^{\omega_{i,i'}} \end{aligned} \quad (1.71)$$

Next, we need to express sectoral labor demand as a function of aggregate labor. We do this by computing the ratio of sectoral labor demand to total labor demand,  $\kappa_{i,t} := L_{i,t}/L_t$ . Using equation(1.24), we find the ratio

$$\kappa_{i,t} = \frac{\left( \frac{m c_{i,t}}{w_{i,t}} \frac{1}{p_{i,t}} s_{i,t} \right) \eta_{i,t}}{\left[ \sum_{i'=1}^N \left( \frac{m c_{i',t}}{w_{i',t}} \frac{1}{p_{i',t}} s_{i',t} \eta_{i',t} \right)^{1+\varphi} \right]^{\frac{1}{1+\varphi}}}, \quad (1.72)$$

which is another function of the endogenous variables of the model.

Finally, using (1.25) we can write intermediate input demands as functions of prices,

price dispersion and Domar weights,

$$\begin{aligned}
X_{i,i',t} &= \omega_{i,i'} \frac{m c_{i,t} s_{i,t} Y_{i,t} p_{i,t}}{p_{i,t}} \frac{C_t}{Y_{i',t} p_{i',t}} Y_{i',t} \\
&= \omega_{i,i'} \frac{m c_{i,t} s_{i,t}}{p_{i,t}} \frac{\eta_{i,t}}{\eta_{i',t}} Y_{i',t}.
\end{aligned} \tag{1.73}$$

### Proof of Proposition

*Proof.* Combining (1.71), (1.73) and the definition of  $\kappa_{i,t}$ , the log of sectoral output is given by

$$\log(Y_{i,t}) = a_{i,t} + z_{i,t}^p + \delta \log(L_t) + \sum_{i'=1}^N \omega_{i,i'} \log(Y_{i',t}),$$

where  $a_{i,t} := \delta \log(\kappa_{i,t}) + \sum_{i'=1}^N \omega_{i,i'} \log\left(\omega_{i,i'} \frac{m c_{i,t} s_{i,t}}{p_{i,t}} \frac{\eta_{i,t}}{\eta_{i',t}}\right)$  is an endogenous variable of the model. Expressing this equation in vectorial form, solving for the sectoral vector of total output and using the constant returns to scale assumption of the production functions yields

$$\log(\mathbf{Y}_t) = (\mathbf{I} - \mathbf{\Omega})^{-1} (\mathbf{a}_t + \mathbf{z}_t^p) + \log(L_t). \tag{1.74}$$

To finally get the aggregate production function let us recall from the definition of Domar weight that  $\eta_{i,t} = \frac{Y_{i,t} p_{i,t}}{C_t}$ . On the other hand, from the optimality condition of the household  $\frac{\alpha_i}{C_{i,t}} = \frac{p_{i,t}}{C_t}$ , thus the Domar weight can be expressed in terms of sectoral consumption as  $\eta_{i,t} = Y_{i,t} \frac{\alpha_i}{C_{i,t}}$ , or

$$\log(C_{i,t}) = \tilde{\alpha}_{i,t} + \log(Y_{i,t}), \tag{1.75}$$

where  $\tilde{\alpha}_{i,t} := \log\left(\frac{\alpha_i}{\eta_{i,t}}\right)$ . Since  $\log(C_t) = \sum_{i=1}^N \alpha_i \log(C_{i,t})$  this represents the final element needed to compute the aggregate production function. Combining (1.74) and (1.75) the aggregate production function is

$$C_t = TFP_t \cdot L_t$$

$$TFP_t = \exp\left\{\boldsymbol{\alpha}' \left[\tilde{\boldsymbol{\alpha}}_t + (\mathbf{I} - \boldsymbol{\Omega})^{-1} (\mathbf{a}_t + \mathbf{z}_t^p)\right]\right\}.$$

Evaluating this expression in steady state yields equation (1.33). □

## 1.C Appendix to Section 1.6

### 1.C.1 Generalized Aggregate New Keynesian Philips Curve

By manipulating equation (1.68) we get an expression for  $\hat{\boldsymbol{\psi}}_t$  that can be substituted in (1.67) to get

$$\begin{aligned} \hat{\boldsymbol{\Pi}}_t &= \left[ \text{diag} \left( \frac{(1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (1 - \theta_i \beta \bar{\Pi}_i^{\epsilon-1})}{\theta_i \bar{\Pi}_i^{\epsilon-1}} \right) (\mathbf{1}\sigma - \mathbb{Y}_c) + \frac{1 + \varphi}{1 + (1 - \delta)\varphi} \text{diag} \left( \frac{(1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (1 - \theta_i \beta \Pi_i^\epsilon)}{\theta_i \bar{\Pi}_i^{\epsilon-1}} \right) (\mathbb{Y}_c - (1 - \delta)\sigma \mathbf{1}) \right] \hat{C}_t \\ &+ \left[ \frac{1 + \varphi}{1 + (1 - \delta)\varphi} \text{diag} \left( \frac{(1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (1 - \theta_i \beta \Pi_i^\epsilon)}{\theta_i \bar{\Pi}_i^{\epsilon-1}} \right) (\boldsymbol{\Omega} + \mathbb{Y}_p) - \text{diag} \left( \frac{(1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (1 - \theta_i \beta \bar{\Pi}_i^{\epsilon-1})}{\theta_i \bar{\Pi}_i^{\epsilon-1}} \right) (\mathbf{I} + \mathbb{Y}_p) \right] \hat{\mathbf{P}}_t \\ &+ \left[ \frac{1}{1 + (1 - \delta)\varphi} \text{diag} \left( \frac{(1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (1 - \theta_i \beta \Pi_i^\epsilon)}{\theta_i \bar{\Pi}_i^{\epsilon-1}} \right) ((1 + \varphi)\mathbb{Y}_s + \delta\varphi\mathbf{I}) - \text{diag} \left( \frac{(1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (1 - \theta_i \beta \bar{\Pi}_i^{\epsilon-1})}{\theta_i \bar{\Pi}_i^{\epsilon-1}} \right) \mathbb{Y}_s \right] \hat{\mathbf{s}}_t \\ &+ \text{diag} \left( (1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) \left( 1 + \epsilon(\Pi_i - 1) + \frac{\theta_i \bar{\Pi}_i^{\epsilon-1}}{1 - \theta_i \bar{\Pi}_i^{\epsilon-1}} \right) \right) \beta \mathbb{E}_t [\hat{\boldsymbol{\Pi}}_{t+1}] \\ &+ \text{diag} \left( (1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (\bar{\Pi}_i - 1) \right) \beta \mathbb{E}_t [\hat{\boldsymbol{\psi}}_{t+1}] \\ &+ \left[ \frac{1 + \varphi}{1 + (1 - \delta)\varphi} \text{diag} \left( \frac{(1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (1 - \theta_i \beta \Pi_i^\epsilon)}{\theta_i \bar{\Pi}_i^{\epsilon-1}} \right) (\mathbb{Y}_z - \mathbf{I}) - \text{diag} \left( \frac{(1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (1 - \theta_i \beta \bar{\Pi}_i^{\epsilon-1})}{\theta_i \bar{\Pi}_i^{\epsilon-1}} \right) \mathbb{Y}_z \right] \hat{\mathbf{z}}_t^p. \end{aligned} \quad (1.76)$$

The aggregate NKPC is generated by premultiplying equation (1.76) by the consumption

shares  $\alpha'$ ,

$$\hat{\Pi}_t = \Phi_c \hat{C}_t + \sum_{i=1}^N \left[ \Phi_i^p \hat{p}_{i,t} + \Phi_i^s \hat{s}_{i,t} + \beta \Phi_i^\pi \mathbb{E}_t \left[ \hat{\Pi}_{i,t+1} \right] + \beta \Phi_i^\psi \mathbb{E}_t \left[ \hat{\psi}_{i,t+1} \right] + \Phi_i^z z_{i,t}^p \right] \quad (1.77)$$

where the coefficient of output gap is given by

$$\Phi_c = \alpha' \left[ \text{diag} \left( \frac{(1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (1 - \theta_i \beta \bar{\Pi}_i^{\epsilon-1})}{\theta_i \bar{\Pi}_i^{\epsilon-1}} \right) (\mathbf{1}\sigma - \mathbb{Y}_c) + \frac{1 + \varphi}{1 + (1 - \delta)\varphi} \text{diag} \left( \frac{(1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (1 - \theta_i \beta \bar{\Pi}_i^{\epsilon-1})}{\theta_i \bar{\Pi}_i^{\epsilon-1}} \right) (\mathbb{Y}_c - (1 - \delta)\sigma\mathbf{1}) \right],$$

and the weights  $\Phi_i^x$  for  $x = p, s, \pi, \psi, z$  represent the  $i$ -th element of the  $1 \times N$  vectors  $\Phi^x$  defined below

$$\begin{aligned} \Phi^p &= \alpha' \left[ \frac{1 + \varphi}{1 + (1 - \delta)\varphi} \text{diag} \left( \frac{(1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (1 - \theta_i \beta \bar{\Pi}_i^{\epsilon-1})}{\theta_i \bar{\Pi}_i^{\epsilon-1}} \right) (\Omega + \mathbb{Y}_p) - \text{diag} \left( \frac{(1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (1 - \theta_i \beta \bar{\Pi}_i^{\epsilon-1})}{\theta_i \bar{\Pi}_i^{\epsilon-1}} \right) (\mathbf{1} + \mathbb{Y}_p) \right] \\ \Phi^s &= \alpha' \left[ \frac{1}{1 + (1 - \delta)\varphi} \text{diag} \left( \frac{(1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (1 - \theta_i \beta \bar{\Pi}_i^{\epsilon-1})}{\theta_i \bar{\Pi}_i^{\epsilon-1}} \right) ((1 + \varphi)\mathbb{Y}_s + \delta\varphi\mathbf{1}) - \text{diag} \left( \frac{(1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (1 - \theta_i \beta \bar{\Pi}_i^{\epsilon-1})}{\theta_i \bar{\Pi}_i^{\epsilon-1}} \right) \mathbb{Y}_s \right] \\ \Phi^\pi &= \alpha' \text{diag} \left( (1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) \left( 1 + \epsilon(\Pi_i - 1) + \frac{\theta_i \bar{\Pi}_i^{\epsilon-1}}{1 - \theta_i \bar{\Pi}_i^{\epsilon-1}} \right) \right) \\ \Phi^\psi &= \alpha' \text{diag} \left( (1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (\bar{\Pi}_i - 1) \right) \\ \Phi^z &= \alpha' \left[ \frac{1 + \varphi}{1 + (1 - \delta)\varphi} \text{diag} \left( \frac{(1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (1 - \theta_i \beta \bar{\Pi}_i^{\epsilon-1})}{\theta_i \bar{\Pi}_i^{\epsilon-1}} \right) (\mathbb{Y}_z - \mathbf{1}) - \text{diag} \left( \frac{(1 - \theta_i \bar{\Pi}_i^{\epsilon-1}) (1 - \theta_i \beta \bar{\Pi}_i^{\epsilon-1})}{\theta_i \bar{\Pi}_i^{\epsilon-1}} \right) \mathbb{Y}_z \right]. \end{aligned}$$

Pasten, Shoenle and Weber 2016

Pasten et al. (2016b) study the real effects of multi-sector model with production networks and sectoral heterogeneity of price stickiness. To reproduce this setting I need to set trend inflation equal to zero in every sector, i.e.  $\bar{\Pi}_i = 1$ . This produces the following NKPC

$$\hat{\Pi}_t = \Phi_c \hat{C}_t + \beta \mathbb{E}_t \left[ \hat{\Pi}_{t+1} \right] + \sum_{i=1}^N \left[ \Phi_i^p \hat{p}_{i,t} + \Phi_i^z z_{i,t}^p \right] \quad (1.78)$$

where the coefficient of output gap is given by

$$\Phi_c = \alpha' \left[ \text{diag} \left( \frac{(1 - \theta_i)(1 - \theta_i \beta)}{\theta_i} \right) (\mathbf{1}\sigma - \mathbb{Y}_c) + \frac{1 + \varphi}{1 + (1 - \delta)\varphi} \text{diag} \left( \frac{(1 - \theta_i)(1 - \theta_i \beta)}{\theta_i} \right) (\mathbb{Y}_c - (1 - \delta)\sigma\mathbf{1}) \right],$$

and the weights  $\Phi_i^x$  for  $x = p, z$  represent the  $i$ -th element of the  $1 \times N$  vectors  $\Phi^x$  defined below

$$\begin{aligned}\Phi^p &= \alpha' \left[ \frac{1+\varphi}{1+(1-\delta)\varphi} \text{diag} \left( \frac{(1-\theta_i)(1-\theta_i\beta)}{\theta_i} \right) (\mathbf{\Omega} + \mathbb{Y}_p) - \text{diag} \left( \frac{(1-\theta_i)(1-\theta_i\beta)}{\theta_i} \right) (\mathbf{I} + \mathbb{Y}_p) \right] \\ \Phi^z &= \alpha' \left[ \frac{1+\varphi}{1+(1-\delta)\varphi} \text{diag} \left( \frac{(1-\theta_i)(1-\theta_i\beta)}{\theta_i} \right) (\mathbb{Y}_z - \mathbf{I}) - \text{diag} \left( \frac{(1-\theta_i)(1-\theta_i\beta)}{\theta_i} \right) \mathbb{Y}_z \right].\end{aligned}$$

The NKPC (1.78) combines equations (1.67) and (1.68) from the log-linearized system. On the other hand, replacing  $\bar{\Pi}_i = 1$  in (1.66) implies the sectoral variables  $\hat{s}_{i,t}$  are no longer relevant in the system. Therefore in this case the log-linearized system is simpler and the optimal dynamics can be described with equation (1.78) and 3 more equations,

$$0 = \mathbb{E}_t \left[ \hat{C}_{t+1} \right] + \frac{1}{\sigma} \left( \mathbb{E}_t \left[ \hat{\Pi}_{t+1} \right] - \hat{I}_t \right) - \hat{C}_t \quad (1.79)$$

$$0 = \rho_I \hat{I}_{t-1} + (1 - \rho_I) \left( \phi_c \hat{C}_t + \phi_\pi \hat{\Pi}_t \right) + z_t^m - \hat{I}_t \quad (1.80)$$

$$\mathbf{0} = \hat{\mathbf{p}}_{t-1} + (\mathbf{I} - \mathbf{1}\alpha') \hat{\mathbf{\Pi}}_t - \hat{\mathbf{p}}_t. \quad (1.81)$$

Carvalho 2006

The results from Carvalho (2006) can be reproduced by assuming no production networks and no trend inflation. An online appendix shows that  $\mathbf{\Omega} = \mathbf{0}$  implies  $\mathbb{Y}_c = \mathbf{1}$ ,  $\mathbb{Y}_p = -\mathbf{I}$ ,  $\mathbb{Y}_s = \mathbf{0}$ ,  $\mathbb{Y}_z = \mathbf{0}$  and the no trend inflation assumption implies  $\bar{\Pi}_i = 1$  for every sector  $i$ , so

$$\hat{\mathbf{\Pi}}_t = \beta \mathbb{E}_t \left[ \hat{\mathbf{\Pi}}_{t+1} \right] + \Phi_c \hat{C}_t + \sum_{i=1}^N \Phi_i^p \hat{p}_{i,t} + \sum_{i=1}^N \Phi_i^z z_{i,t}^p \quad (1.82)$$

where the coefficients of the NKPC are given by

$$\begin{aligned}\Phi_c &= (\sigma + \varphi) \sum_{i=1}^N \alpha_i \frac{(1-\theta_i)(1-\theta_i\beta)}{\theta_i} \\ \Phi_i^p &= -(1+\varphi) \left( \alpha_i \frac{(1-\theta_i)(1-\theta_i\beta)}{\theta_i} \right) \\ \Phi_i^z &= -(1+\varphi) \frac{(1-\theta_i)(1-\theta_i\beta)}{\theta_i} \alpha_i.\end{aligned}$$

Ascari and Sbordone 2014

To reproduce the results from Ascari and Sbordone (2014) we need to set  $N = 1$ , so  $\mathbf{\Omega} = 0$   $\mathbb{Y}_c = 1, \mathbb{Y}_p = -1, \mathbb{Y}_s = 0, \mathbb{Y}_z = 0$  are now scalars. The NKPC now becomes

$$\hat{\Pi}_t = \Phi^c \hat{C}_t + \Phi^\pi \beta \mathbb{E}_t [\hat{\Pi}_{t+1}] + \Phi^\psi \beta \mathbb{E}_t [\hat{\psi}_{t+1}] + \Phi^s \hat{s}_t + \Phi^z z_t^p \quad (1.83)$$

where the coefficients are now given by

$$\begin{aligned} \Phi^c &= \left( \frac{(1 - \theta \bar{\Pi}^{\epsilon-1})(1 - \theta \beta \Pi^\epsilon)}{\theta \bar{\Pi}^{\epsilon-1}} \right) (\sigma + \varphi) + \beta (1 - \theta \bar{\Pi}^{\epsilon-1}) (1 - \bar{\Pi}) (1 - \sigma) \\ \Phi^\pi &= (1 + \epsilon (1 - \theta \bar{\Pi}^{\epsilon-1}) (\Pi - 1)) \\ \Phi^\psi &= (1 - \theta \bar{\Pi}^{\epsilon-1}) (\bar{\Pi} - 1) \\ \Phi^s &= \varphi \left( \frac{(1 - \theta \bar{\Pi}^{\epsilon-1})(1 - \theta \beta \bar{\Pi}^\epsilon)}{\theta \bar{\Pi}^{\epsilon-1}} \right) \\ \Phi^z &= -(1 + \varphi) \frac{(1 - \theta \bar{\Pi}^{\epsilon-1})(1 - \theta \beta \Pi^\epsilon)}{\theta \bar{\Pi}^{\epsilon-1}} \end{aligned}$$

### Standard New Keynesian Philips Curve

The standard NKPC can be found by setting trend inflation equal to zero, i.e.  $\bar{\Pi} = 1$  in equation (1.83). This yields

$$\hat{\Pi}_t = \Phi^c \hat{C}_t + \beta \mathbb{E}_t [\hat{\Pi}_{t+1}] + \Phi^z z_t^p \quad (1.84)$$

where the coefficients are now given by

$$\begin{aligned} \Phi^c &= \left( \frac{(1 - \theta)(1 - \theta \beta)}{\theta} \right) (\sigma + \varphi) \\ \Phi^z &= -(1 + \varphi) \frac{(1 - \theta)(1 - \theta \beta)}{\theta}. \end{aligned}$$

The term involving  $\hat{s}_t$  is ignored in this case since it does not matter in a first order approximation.

# CHAPTER 2

## A NEW KEYNESIAN PERSPECTIVE ON TOTAL FACTOR PRODUCTIVITY VIA PRODUCTION NETWORKS

This chapter is based on a joint paper with Francesca Loria

### 2.1 Introduction

This paper seeks to study the effect of monopolistic competition, sticky prices and production networks on both the steady state level and the business cycle movements of the total productivity of factors (TFP). To address these questions we provide a multi-sector New Keynesian model in which sectors are related to each other by input-output production linkages. The model is calibrated to the 2015 Bureau of Economic Analysis (BEA) input-output (I-O) tables and features monopolistic competition as well as à la Calvo price frictions.

An aggregate production function is derived to show that (i) the level of the Solow residual is a function of technology, cost-push shocks, sectoral markups and the production network, (ii) monetary shocks can have a short run impact on TFP through their effect on individual markups and (iii) the presence of production networks as defined by the input-output linkages can amplify the gap between Solow’s residual and true technology. In a nutshell, what we show is that, in the presence of production networks, measured TFP and pure productivity shocks are not the same (i.e.,  $TFP \neq z^p$ ). More specifically, we derive that

$$Y = f(z^p, L, K, X) \neq z^p g(L, K) h(X) \tag{2.1}$$

$$\Rightarrow \frac{Y}{h(X)} = \frac{f(z^p, L, K, X)}{h(X)} = \frac{TFP(z^p, X, \Omega, \mu) g(L, K)}{h(X)} \neq z^p g(L, K) = C \tag{2.2}$$

where  $Y$  is gross output,  $C$  is net, value-added output (i.e., GDP),  $L$  is labor,  $K$  is capital,  $X$  are intermediate inputs,  $f(\cdot)$  is a function that maps production inputs to output,  $h(\cdot)$  a function that links intermediate inputs to final output,  $\Omega$  describes the input-output pro-

duction linkages and  $\mu$  stands for the (sectoral) price markups. On the other hand, in the absence of production networks

$$\frac{Y}{h(X)} = \frac{f(z^p, L, K, X)}{h(X)} = \frac{z^p g(L, K) h(X)}{h(X)} = C, \quad (2.3)$$

so that  $TFP = z^p$  is independent of the production network channel.

In the presence of production networks, the key mechanism works as follows. Firms within each sector face monopolistic competition, which results in sector-level markups. The inefficiencies produced by these markups are amplified by the network structure creating losses in aggregate productivity. Moreover, pricing frictions modeled as in Calvo (1983) lead to a misalignment from optimal pricing and thus affect the aggregate measure of productivity. The greater the price stickiness, the more elastic are markups to exogenous shocks and, thus, the more responsive is TFP. Finally, heterogeneity in firm's staggered price setting also acts as an amplification device.

Our main findings are that monopolistic competition negatively affects TFP and that the presence of networks amplifies this effect. As to the steady state TFP level, we find that (i) for a given level of average price markup, more connected networks reduce TFP more and (ii) for a given network, the loss in TFP can vary steeply with the average markup in the economy. With respect to the dynamic behavior of TFP, we find that it depends crucially on the presence of networks. Indeed, without production networks TFP only varies with productivity shocks. However, in the presence of networks, TFP is also affected by monetary policy and cost-push shocks. From a qualitative standpoint, the way markups respond to shocks is key in understanding whether TFP is negatively or positively affected. In particular, in our model an increase in markups makes the economy less efficient and this inefficiency is amplified differently by network type.

At least since Solow (1957) aggregate productivity change has been a central piece in debates related to economic growth and researchers have invested a non-negligible amount of time and effort in trying to understand better what determines the growth rate of aggregate productivity and its fluctuations around that rate (e.g., Lucas, 1988) or Kydland and Prescott

(1982) are seminal papers related to this). In most of these efforts the analysis has been done at the aggregated level, abstracting from the fact that modern economies are composed by complex networks of input and output relations between firms and consumers. This approach can be attributed to the work of Hulten (1978), where under perfect competition and a set of regular assumptions the aggregate impact of sectoral productivity shocks is shown to equal the share of that sector's sales on total output. As an implication, the shares of sectoral sales are sufficient statistics for the impact of idiosyncratic productivity shocks on aggregate productivity. Under these conditions there is no need to model a disaggregated and more realistic economy since the (appropriately) weighted sum of sectoral productivity shocks is a sufficient statistic of the aggregate impact of these shocks. It then follows that the weighted sum of sectoral shocks can be recast as an aggregate shock. A more extreme version of this argument is made in Lucas (1981) by arguing that when the level of disaggregation of an economy increases, the law of large numbers implies that idiosyncratic shocks of different firms or sectors should average out. Under this view only aggregate shocks would matter to explain fluctuations in aggregate productivity.

However, a relatively new branch of the macroeconomic literature has pointed out the importance of idiosyncratic shocks in order to explain aggregate fluctuations. On the one hand there's a granularity argument initially proposed by Gabaix (2011): The fat tail of the firm-size distribution invalids the law of large numbers argument because the idiosyncratic shocks to the larger firms of the economy do not average out in the aggregate. On the other hand, Acemoglu et al. (2012) show how production networks can amplify sectoral shocks depending on the structure of the input-output linkages. Since then other papers have followed this route<sup>1</sup>. For example, Acemoglu et al. (2015) explore how demand-side and supply-side shocks propagate in an economy with network structures, and Carvalho et al. (2017) measure the aggregate effects on the Japanese economy of an exogenous disruption of the production network due to the 2011 earthquake. A multi-sector New Keynesian model is used by Pasten et al. (2016a) and Pasten et al. (2017) to respectively quantify the real effects of monetary shocks in economies with production networks and to study the implications of sectoral shocks on GDP volatility.

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1. See Carvalho (2014) for a comprehensive review of the literature.

Contrary to the aforementioned papers, we do not focus on explaining how aggregate fluctuations can arise from microeconomic shocks, but we rather try to characterize how the Solow residual reacts to different types of shocks. In this sense our work, is closer to the one of Basu and Fernald (2002) where the authors show that aggregate productivity can differ from aggregate technology due to the presence of different gaps. Our model is also related to Basu (1995) since it yields monetary-induced productivity fluctuations in addition to the mechanisms of imperfect competition and input-output linkages. We believe our model represents a more realistic framework to be mapped into the data since we introduce capital into the analysis and the input-output linkages can be directly calibrated by using the I-O tables published by the U.S. Bureau of Economic Analysis.

From an empirical standpoint, there is ample evidence that measured productivity is not strictly exogenous. For instance, Evans (1992) finds that money, interest rates and government spending Granger-cause measured TFP, Mankiw (1989) examines data from the early 1940s and finds that the surge in TFP from 1939 to 1944 is likely a demand-driven response to the military buildup of World War II, Hall (1988) and Hall (1989) both discard invariance properties of the Solow residual in favour of noncompetitive forces affecting the latter. A similar result is established in Caballero and Lyons (1992) who find evidence of external increasing returns in sectoral data. Finally, Levinsohn and Petrin (2003) use intermediate goods as a proxy for productivity.

Studies of resource misallocation like the ones of Hsieh and Klenow (2009) and Jones (2011) are also related to our work. Although we do not provide measures of marginal products of labor and capital as in Hsieh and Klenow (2009) we do identify the factors that lower total productivity, which would allow a country-by-country comparison of these factors. As in Jones (2011), we use a multi-sector economy to explain how production networks can affect the total productivity of an economy. However, our paper deviates from Jones (2011) in two important aspects. First, we introduce imperfect competition to the analysis, allowing productivity to depend on the sectoral markups of the economy. This channel can be important even if the markups are low due to the amplification of the network structure. Second, our model can be used to analyze the behavior of productivity not only in a static but also in a dynamic dimension by studying the responses of aggregate productivity

to different types of shocks.

The remaining structure of this paper is the following. Section 2.2 develops a multi-sector New Keynesian model with production networks. Contrary to the usual one-sector New Keynesian model, the framework of Section 2.2 requires to introduce sectoral price gaps as state-variables of the model. The model converges to the benchmark case only under homogeneity of price stickiness across sectors and no presence of idiosyncratic shocks. This implies different optimal dynamics for the variables of the model and hence, for aggregate productivity. Section 2.3 derives an expression for the aggregate productivity as a function of the variables of the model and characterizes the conditions under which aggregate productivity coincides with the aggregate technology level. The results of Section 2.3 are then used in Section 2.4 to analyze how productivity behaves dynamically under different types of shocks. It also reports how the level of productivity changes for different configurations of the economy. Finally, Section 2.5 concludes and presents future research avenues.

## 2.2 A New Keynesian Model with Production Networks

The theoretical model builds up on the work of Castro Cienfuegos (2018).

### 2.2.1 Households

The economy is composed of a representative household with preferences over aggregate consumption and leisure. Infinitely lived, it maximizes

$$\mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t \left( \frac{C_t^{1-\sigma}}{1-\sigma} - \frac{L_t^{1+\varphi}}{1+\varphi} \right), \quad (2.4)$$

where  $\beta$  is the time discount factor,  $\sigma$  the inverse elasticity of substitution and  $\varphi$  the inverse Frisch elasticity of labor supply.  $L_t$  denotes employment and  $C_t$  is a Cobb-Douglas aggregator

of  $N$  sectoral consumption bundles

$$C_t := \prod_{i=1}^N C_{i,t}^{\alpha_i}. \quad (2.5)$$

Each sectoral bundle is defined as a CES aggregator composed by the products of a continuum of firms between  $[0, 1]$ , so

$$C_{i,t} := \left( \int_0^1 C_{i,j,t}^{\frac{\epsilon-1}{\epsilon}} dj \right)^{\frac{\epsilon}{\epsilon-1}}, \quad (2.6)$$

where  $C_{i,j,t}$  is the quantity of good produced by firm  $j$  in industry  $i$  at time  $t$  and  $\epsilon$  is the constant elasticity of substitution.

The problem of the household implies the following optimal demands for the composite good of sector  $i$  and individual good  $j$  of sector  $i$

$$C_{i,t} = \alpha_i \frac{C_t P_t}{P_{i,t}}, \quad (2.7)$$

$$C_{i,j,t} = \left( \frac{P_{i,j,t}}{P_{i,t}} \right)^{-\epsilon} C_{i,t}, \quad (2.8)$$

where  $P_t$  is the consumer price index defined by

$$P_t := \prod_{i=1}^N \left( \frac{P_{i,t}}{\alpha_i} \right)^{\alpha_i}. \quad (2.9)$$

The budget constraint of the representative household is

$$\sum_{i=1}^N \int_0^1 P_{i,j,t} C_{i,j,t} dj + Q_t^B B_t + \sum_{i=1}^N P_t Q_t \left[ K_{i,t+1} - (1 - \delta^k) K_{i,t} \right] \leq B_{t-1} + \sum_{i=1}^N (W_t L_{i,t} + Z_t K_{i,t} + A_{i,t}), \quad (2.10)$$

where  $P_{i,j,t}$  is the price charged by firm  $j$  in sector  $i$ ,  $B_t$  denotes holdings of one-period discount bonds,  $Q_t^B \equiv \frac{1}{1+i_t}$  is the unitary price of the bond and  $i_t$  is the net nominal interest rate,  $L_{i,t}$  is labor supplied to sector  $i$ ,  $W_t$  is the wage rate,  $Q_t$  is the unitary price of capital<sup>2</sup>,

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2. Note that the wage rate and the real rental rate of capital are the same across sectors, we thus impose a perfectly competitive labor and capital market across sectors. Also, since capital producers choose investment

$K_{i,t}$  is capital supplied to sector  $i$ ,  $Z_t$  is the rental rate of capital, and  $A_{i,t} = \int_0^1 A_{i,j,t} dj$  denotes dividends from all firms in sector  $i$ . The budget constraint can be recast as

$$P_t C_t + Q_t^B B_t + P_t Q_t \left[ K_{t+1} - (1 - \delta^k) K_t \right] \leq B_{t-1} + W_t L_t + Z_t K_t + A_t \quad (2.11)$$

since  $\sum_{i=1}^N P_{i,t} C_{i,t} = P_t C_t = Z_t^C$  and where  $L_t$ ,  $K_t$  and  $A_t$  are the sum of supplied sectoral labor, capital and dividends, respectively.

The representative household maximizes expected lifetime utility

$$\max_{\{C_t, L_t, B_t, K_{t+1}\}_{t=0}^{\infty}} \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t \left( \frac{C_t^{1-\sigma}}{1-\sigma} - \frac{L_t^{1+\varphi}}{1+\varphi} \right) \quad (2.12)$$

subject to the budget constraint (2.11). The associated first order conditions are given by

$$w_t - p_t = \sigma c_t + \varphi \ell_t, \quad (2.13)$$

$$c_t = E_t \{ c_{t+1} \} - \frac{1}{\sigma} (i_t - \mathbb{E}_t \{ \pi_{t+1} \} - \rho), \quad (2.14)$$

$$c_t = E_t \{ c_{t+1} \} - \frac{1}{\sigma} (\mathbb{E}_t \{ r_{t+1} \} - \rho). \quad (2.15)$$

where lower case variables denote log levels (i.e.,  $x_t = \log(X_t)$ ).

### 2.2.2 Firms

Within each sector  $i = 1, \dots, N$  there is a continuum of atomistic infinitely lived firms indexed by  $j \in [0, 1]$ . Each firm  $j$  within a sector  $i$  produces with the same CRS production function,

$$Y_{i,j,t} = e^{z_{i,t}^p} \left( K_{i,j,t}^\gamma L_{i,j,t}^{1-\gamma} \right)^\delta \prod_{i'=1}^N X_{i,j,i',t}^{\omega_{i,i'}} \quad (2.16)$$

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so as to maximize  $Q_t I_t - I_t$  the capital price will be equal to 1.

where  $z_{i,t}^p$  is a pure productivity shock,  $K_{i,j,t}$  is capital,  $L_{i,j,t}$  is labor and  $X_{i,j,i',t}$  is a CES composite good made from products of firms in industry  $i'$ ,

$$X_{i,j,i',t} := \left( \int_0^1 X_{i,j,i',j',t}^{\frac{\epsilon^f-1}{\epsilon^f}} dj' \right)^{\frac{\epsilon^f}{\epsilon^f-1}}. \quad (2.17)$$

The total cost of producing a quantity  $Y_{i,j,t}$  is given by

$$C(Y_{i,j,t}) = W_t L_{i,j,t} + Z_t K_{i,j,t} + \sum_{i'=1}^N \int_0^1 P_{i',j',t}^p X_{i,j,i',j',t} dj', \quad (2.18)$$

so profits in terms of aggregate units of consumption are  $A_{i,j,t} = \frac{P_{i,j,t} Y_{i,j,t} - C(Y_{i,j,t})}{P_t}$ . Concurrently, an individual firm  $(i,j)$  faces a total demand composed by consumption demand (2.8) and the sum of input demands from all firms  $j'$  of all other sectors  $i'$ ,  $X_{i',j',i,j,t}$ . Total input demand faced by firm  $(i,j)$  is given by  $\sum_{i'=1}^N \int_0^1 X_{i',j',i,j,t} dj'$  so that the goods market clearing condition reads

$$Y_{i,j,t}^d = C_{i,j,t} + \sum_{i'=1}^N \int_0^1 X_{i',j',i,j,t} dj'. \quad (2.19)$$

A firm  $(i,j)$  then has to choose its optimal price  $P_{i,j,t}$  in order to maximize profits  $A_{i,j,t}$  subject to the individual demand  $Y_{i,j,t}^d$ . It can be shown that optimality requires an optimal mix of inputs given by  $X_{i,j,i',j',t} = \left( \frac{P_{i',j',t}^p}{P_{i,j,t}} \right)^{\epsilon^f} X_{i,j,i',t}$ , where  $P_{i',j',t}^p$  is a production price index defined by  $P_{i',j',t}^p := \left( \int_0^1 P_{i',j',t}^{1-\epsilon^f} dj \right)^{\frac{1}{1-\epsilon^f}}$ . The symmetry of the problem implies that the input demand faced by firm  $(i,j)$  also takes that form. Then total demand for firm  $(i,j)$  is

$$Y_{i,j,t}^d = C_{i,t} \left( \frac{P_{i,t}}{P_{i,j,t}} \right)^\epsilon + \sum_{i'=1}^N X_{i',i,t} \left( \frac{P_{i,t}^p}{P_{i,j,t}} \right)^{\epsilon^f}, \quad (2.20)$$

where, given the large number of firms within each sector  $i$ , the quantities  $C_{i,t}$  and  $X_{i',i,t}$  and prices  $P_{i,t}$  and  $P_{i,t}^p$  are taken as exogenously given by firm  $(i,j)$ .

Firms within a particular sector face a probability  $1 - \theta_i$  of resetting their prices each period and solve the following optimization problem

$$\max_{P_{i,j,t}} \mathbb{E}_t \left\{ \sum_{m=0}^{\infty} \Lambda_{t,t+m} \theta_i^m \left[ \frac{P_{i,j,t} Y_{i,j,t+m|t}^d - \mathcal{C}(Y_{i,j,t+m|t})}{P_{t+m}} \right] \right\} \quad (2.21)$$

$$\text{s.t. } \mathcal{C}(Y_{i,j,t+m|t}) = W_{t+m|t} L_{i,j,t+m|t} + Z_{t+m|t} K_{i,j,t+m|t} + \sum_{i'=1}^N P_{i',t+m}^p X_{i,j,i',t+m|t} \quad (2.22)$$

$$Y_{i,j,t+m|t}^d = C_{i,t+m} \left( \frac{P_{i,t+m}}{P_{i,j,t}} \right)^\epsilon + \sum_{i'=1}^N X_{i',i,t+m} \left( \frac{P_{i,t+m}^p}{P_{i,j,t}} \right)^{\epsilon^f} \quad (2.23)$$

In the following, we will assume that  $\epsilon = \epsilon^f$  and, thus,  $P_{i,t} = P_{i,t}^p$ . A log-linearization of the first order condition of a typical firm in sector  $i$  around the zero-inflation flexible-price steady state yields

$$p_{i,t}^* = (1 - \beta\theta_i) \sum_{m=0}^{\infty} (\beta\theta_i)^m \mathbb{E}_t \left\{ \mu_{i,t+m}^* + \psi_{i,t+m} \right\}, \quad (2.24)$$

where  $\mu_{i,t}^* := \log \mathcal{M}_{i,t}$  and  $\psi_{i,t+m} := \log \Psi_{i,t+m}$  are the log-markup and log-marginal cost of a firm that last reset its price in period  $t$ .

We can express the log-optimal markup in terms of a cost-push shock  $\mu_{i,t}^* := \mu_i + z_{i,t}^{cp}$  where  $z_{i,t}^{cp} := (\mu_{i,t}^* - \mu_i)$ . It is assumed that the cost-push shocks follows the process

$$\mathbf{z}_{t+1}^{cp} = \mathbf{\Lambda}_{cp} \mathbf{z}_t^{cp} + \mathbf{u}_{t+1}^{cp}, \quad (2.25)$$

where  $\mathbf{u}_{t+1}^{cp}$  is i.i.d. with mean  $\mathbf{0}$  and the notation in bold  $\mathbf{x}$  stands for the column stacked vector of sectoral variables  $x_{i,t}$ .

At the sectoral level, the Dixit-Stiglitz price index

$$P_t \equiv \left[ \int_0^1 P_t(i)^{1-\epsilon} di \right]^{\frac{1}{1-\epsilon}} \quad (2.26)$$

follows the law of motion

$$\pi_{i,t} = (1 - \theta_i) \left( p_{i,t}^* - p_{i,t-1} \right). \quad (2.27)$$

Using this condition together with (2.24) it is possible to derive the sectoral pricing equation which, in stacked form, reads

$$\boldsymbol{\pi}_t = \beta \mathbb{E}_t \{ \boldsymbol{\pi}_{t+1} \} - \boldsymbol{\Lambda} \hat{\boldsymbol{\mu}}_t + \boldsymbol{\Lambda} \mathbf{z}_t^{CP}, \quad (2.28)$$

where  $\boldsymbol{\Lambda}$  is a  $N \times N$  diagonal matrix with elements  $\lambda_i := \frac{(1-\theta_i)(1-\beta\theta_i)}{\theta_i}$  in the diagonal and  $\hat{\boldsymbol{\mu}}_t = \boldsymbol{\mu}_t - \boldsymbol{\mu}$  are the stacked sectoral (log) deviations of the average markup from their steady state levels<sup>3</sup>.

### 2.2.3 Monetary Policy

The monetary authority is assumed to set the interest rate according to the Taylor rule

$$i_t = \rho + \phi_\pi \pi_t + \phi_c \hat{c}_t + z_t^m, \quad (2.29)$$

where  $\rho$  is the household's time discount rate,  $\phi_\pi$  and  $\phi_c$  can be respectively thought of as the weights on inflation and on value-added GDP in deviations from its steady state level, and  $z_t^m$  is a monetary policy shock.

### 2.2.4 Model Solution

The objective of this section is to produce the rational expectations system of the model<sup>4</sup>. To this end, we express the solutions of the sticky price equilibrium as a system of four sets of variables: (i) the aggregate consumption gap  $\hat{c}_t$ , (ii) the sectoral inflation rates  $\boldsymbol{\pi}_t$ , (iii) aggregate capital gap  $\hat{k}_{t+1}$ , and (iv) the relative sectoral price gaps  $\hat{\mathbf{p}}_t^R$  defined as sectoral

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3. Notice that since we assume an equal and constant elasticity of substitution  $\epsilon$  steady state markups are the same across sectors.

4. We solve the latter using the Gensys algorithm developed by Sims (2002).

prices in deviations from the economy's average price level  $\hat{\mathbf{p}}_t^R := \hat{\mathbf{p}}_t - \mathbf{1}\bar{p}_t^5$ . The system is hence composed of  $2N + 2$  variables.

First, to obtain the aggregate consumption gap  $\hat{c}_t$ , we combine the Taylor rule described by (2.29) with the Euler equation (2.14) (written in deviations from steady state) and obtain

$$\hat{c}_t = \frac{\sigma}{\sigma + \phi_c} \mathbb{E}_t \{\hat{c}_{t+1}\} + \frac{1}{\sigma + \phi_c} \boldsymbol{\alpha}' \mathbb{E}_t \{\boldsymbol{\pi}_{t+1}\} - \frac{\phi_\pi}{\sigma + \phi_c} \boldsymbol{\alpha}' \boldsymbol{\pi}_t - \frac{1}{\phi_c + \sigma} z_t^m. \quad (2.30)$$

Second, the sectoral inflation rates  $\boldsymbol{\pi}_t$  can be obtained by solving for sectoral markup gaps and using equation (2.28). This produces sectoral New Keynesian Phillips Curves

$$\begin{aligned} \boldsymbol{\pi}_t = & \beta \mathbb{E}_t [\boldsymbol{\pi}_{t+1}] + \frac{\delta}{1 + \varphi(\delta\gamma + 1 - \delta)} (\sigma(1 - \gamma) + \varphi + \gamma) \boldsymbol{\Lambda} \mathbf{1} \hat{c}_t - \frac{\gamma\delta(1 + \varphi)}{1 + \varphi(\delta\gamma + 1 - \delta)} \boldsymbol{\Lambda} \mathbf{1} \hat{k}_t^s \\ & - \boldsymbol{\Lambda} \left[ \mathbf{I} - \boldsymbol{\Omega} + \frac{\delta\varphi}{1 + \varphi(\delta\gamma + 1 - \delta)} \mathbf{1} \left( (1 - \gamma) \boldsymbol{\kappa}' (\mathbf{I} - \boldsymbol{\Omega}) - \left(1 + \frac{1}{\varphi}\right) \boldsymbol{\alpha}' \right) \right] \hat{\mathbf{p}}_t \\ & - \boldsymbol{\Lambda} \left( \mathbf{I} + \mathbf{1} \delta (1 - \gamma) \frac{\varphi}{1 + \varphi(\delta\gamma + 1 - \delta)} \boldsymbol{\kappa}' \right) \mathbf{z}_t^p \\ & + \boldsymbol{\Lambda} \left\{ \mathbf{I} - \mathbf{1} \left[ \left( \delta(1 - \gamma) \frac{\varphi}{1 + \varphi(\delta\gamma + 1 - \delta)} \left( \boldsymbol{\kappa}' + \gamma\delta \left( \boldsymbol{\kappa}^k \right)' \right) + \gamma\delta \left( \boldsymbol{\kappa}^k \right)' \right) \right. \right. \\ & \quad \left. \left. \times (\mathbf{I} - \mathbb{X}')^{-1} \mathbb{X}' + \gamma\delta \left( \boldsymbol{\kappa}^k \right)' \right] \right\} \mathbf{z}_t^{cp}, \end{aligned} \quad (2.31)$$

where  $\boldsymbol{\Omega}$  is the input-output matrix,  $\mathbb{X}$  is a matrix collecting the sectoral intermediate goods to sectoral output ratios and the parameters  $\kappa_i := L_i/L$  and  $\kappa_i^k := K_i/K$  respectively indicate the ratios of sectoral labor and sectoral capital to their aggregates. It can be shown that under symmetry and homogeneity of price stickiness (i.e.,  $\hat{\mathbf{p}}_t = \mathbf{1}\hat{p}_t$  and  $\boldsymbol{\Lambda} = \lambda\mathbf{I}$ ) prices are no longer present on the Phillips curve.

Third, to describe the evolution of the aggregate capital gap  $\hat{k}_{t+1}$  we equate the nominal rental rate of capital of the firm's problem to the real rate of capital of the household's

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5. Relative sectoral price gaps ensure the existence of a solution to the rational expectations system.

problem, which yields

$$\begin{aligned} \hat{k}_{t+1} = & \mathbb{E}_t \{ \hat{c}_{t+1} \} - \frac{\phi_c}{1 - \beta (1 - \delta^k)} \hat{c}_t - \frac{\phi_\pi}{1 - \beta (1 - \delta^k)} \boldsymbol{\alpha}' \boldsymbol{\pi}_t + \frac{1}{1 - \beta (1 - \delta^k)} \boldsymbol{\alpha}' \mathbb{E}_t \{ \boldsymbol{\pi}_{t+1} \} \\ & - \frac{1}{1 - \beta (1 - \delta^k)} z_t^m - \left( \boldsymbol{\kappa}^k \right)' \left( \mathbf{I} + (\mathbf{I} - \mathbb{X}')^{-1} \mathbb{X}' \right) \mathbb{E}_t \left\{ \mathbf{z}_{t+1}^{cp} \right\} \end{aligned} \quad (2.32)$$

where  $\boldsymbol{\kappa}^k$  and  $\mathbb{X}$  are respectively capturing the vector of the steady state sectoral capital to aggregate capital ratios and the matrix of the ratios of demanded sectoral intermediate goods to sectoral outputs.

Finally, log-prices have been defined relative to the aggregate price level in each moment of time, i.e.  $p_{i,t} := \log \frac{P_{i,t}}{P_t}$ . Given the definition of the relative price vector, we can write the law of motion using the identity  $\hat{p}_{i,t} = \hat{p}_{i,t-1} + \pi_{i,t} - \pi_t$ . The law of motion of relative prices is then given by

$$\hat{\mathbf{p}}_t = \hat{\mathbf{p}}_{t-1} + (\mathbf{I} - \mathbf{1}\boldsymbol{\alpha}') \boldsymbol{\pi}_t. \quad (2.33)$$

### 2.2.5 Shocks Structure

All shocks are assumed to follow AR(1) processes with i.i.d. mean zero innovations. The monetary policy shock thus evolves according to

$$z_t^m = \rho_m z_{t-1}^m + \varepsilon_t^m. \quad (2.34)$$

The sectoral productivity and cost-push shocks ( $\mathbf{z}_t^p$  and  $\mathbf{z}_t^{cp}$  respectively) have a common and an idiosyncratic component

$$\mathbf{z}_t^p = \mathbf{1}z_t^p + \mathbf{1}\varepsilon_t^p + \tilde{\mathbf{z}}_t^p + \boldsymbol{\varepsilon}_t^p \quad \text{and} \quad \mathbf{z}_t^{cp} = \mathbf{1}z_t^{cp} + \mathbf{1}\varepsilon_t^{cp} + \tilde{\mathbf{z}}_t^{cp} + \boldsymbol{\varepsilon}_t^{cp}.$$

The common components evolve according to

$$z_t^p = \rho_p z_{t-1}^p + \varepsilon_t^p \quad \text{and} \quad z_t^{cp} = \rho_{cp} z_{t-1}^{cp} + \varepsilon_t^{cp},$$

whereas the idiosyncratic components follow the processes

$$\begin{aligned}\tilde{\mathbf{z}}_t^p &= \begin{bmatrix} z_{1,t}^p \\ z_{2,t}^p \\ \vdots \\ z_{N,t}^p \end{bmatrix} = \begin{bmatrix} \rho_{1,p} z_{1,t-1}^p \\ \rho_{2,p} z_{2,t-1}^p \\ \vdots \\ \rho_{N,p} z_{N,t-1}^p \end{bmatrix} + \begin{bmatrix} \varepsilon_{1,t}^p \\ \varepsilon_{2,t}^p \\ \vdots \\ \varepsilon_{N,t}^p \end{bmatrix} = \mathbf{\Lambda}_p \tilde{\mathbf{z}}_{t-1}^p + \boldsymbol{\varepsilon}_t^p, \\ \tilde{\mathbf{z}}_t^{cp} &= \begin{bmatrix} z_{1,t}^{cp} \\ z_{2,t}^{cp} \\ \vdots \\ z_{N,t}^{cp} \end{bmatrix} = \begin{bmatrix} \rho_{1,cp} z_{1,t-1}^{cp} \\ \rho_{2,cp} z_{2,t-1}^{cp} \\ \vdots \\ \rho_{N,cp} z_{N,t-1}^{cp} \end{bmatrix} + \begin{bmatrix} \varepsilon_{1,t}^{cp} \\ \varepsilon_{2,t}^{cp} \\ \vdots \\ \varepsilon_{N,t}^{cp} \end{bmatrix} = \mathbf{\Lambda}_{cp} \tilde{\mathbf{z}}_{t-1}^{cp} + \boldsymbol{\varepsilon}_t^{cp}.\end{aligned}$$

The vectors of shocks and innovations are thus given by  $\mathbf{z}_t \equiv [z_t^m \ z_t^p \ z_t^{cp} \ \tilde{\mathbf{z}}_t^p \ \tilde{\mathbf{z}}_t^{cp}]'$  and  $\boldsymbol{\varepsilon}_t \equiv [\varepsilon_t^m \ \varepsilon_t^p \ \varepsilon_t^{cp} \ \boldsymbol{\varepsilon}_t^p \ \boldsymbol{\varepsilon}_t^{cp}]'$ . The common and idiosyncratic components are assumed to be uncorrelated. This is standard in the econometric literature of production networks (see Foerster et al., 2011) and allows us to separate the two components in the variance-covariance matrix of the innovations  $\boldsymbol{\Sigma}_\varepsilon$  which thus reads

$$\boldsymbol{\Sigma}_\varepsilon = \begin{bmatrix} \sigma_m^2 & 0 & 0 & \mathbf{0} & \mathbf{0} \\ 0 & \sigma_p^2 & 0 & \mathbf{0} & \mathbf{0} \\ 0 & 0 & \sigma_{cp}^2 & \mathbf{0} & \mathbf{0} \\ 0 & 0 & 0 & \boldsymbol{\Sigma}_p & \mathbf{0} \\ 0 & 0 & 0 & \mathbf{0} & \boldsymbol{\Sigma}_{cp} \end{bmatrix}.$$

The variance-covariance matrices of the innovations to the idiosyncratic productivity and cost-push shocks are described by

$$\boldsymbol{\Sigma}_p = \begin{bmatrix} \sigma_{1,p}^2 & 0 & \dots & 0 \\ 0 & \sigma_{2,p}^2 & \dots & \vdots \\ \vdots & \vdots & \ddots & 0 \\ 0 & 0 & \dots & \sigma_{N,p}^2 \end{bmatrix}, \quad \boldsymbol{\Sigma}_{cp} = \begin{bmatrix} \sigma_{1,cp}^2 & 0 & \dots & 0 \\ 0 & \sigma_{2,cp}^2 & \dots & \vdots \\ \vdots & \vdots & \ddots & 0 \\ 0 & 0 & \dots & \sigma_{N,cp}^2 \end{bmatrix}.$$

### 2.2.6 Production Networks

When studying the static and dynamic determinants of TFP, we consider two prominent production network types studied in the literature<sup>6</sup>.

The first is known as the “star network” and represents the case where only one sector supplies intermediate inputs to itself and to the other sectors in the economy. Figure 2.1 displays such an intermediate goods trade structure.

To get a sense of how the input-output matrix and the consumption weights would look like in such an economy suppose that (i) there are  $N = 4$  sectors in the economy, (ii) sector 4 is the central supplier and (iii) the intermediate goods share is  $(1 - \delta) = 0.5$ . In this case,

$$\mathbf{\Omega} = \begin{bmatrix} 0 & 0 & 0 & 0.5 \\ 0 & 0 & 0 & 0.5 \\ 0 & 0 & 0 & 0.5 \\ 0 & 0 & 0 & 0.5 \end{bmatrix}, \quad \boldsymbol{\alpha} = \begin{bmatrix} 1/3 \\ 1/3 \\ 1/3 \\ 0 \end{bmatrix}$$

and

$$\boldsymbol{\alpha}'\mathbf{H} \equiv \boldsymbol{\alpha}'(\mathbf{I} - \mathbf{\Omega})^{-1} = \begin{bmatrix} 1/3 & 1/3 & 1/3 & 1 \end{bmatrix},$$

where the matrix  $\mathbf{H} := (\mathbf{I} - \mathbf{\Omega})^{-1}$  is known as the Leontief inverse. The typical element  $h_{i,j}$  of this matrix shows the percentage effect of a 1% increase in productivity in sector  $j$  on output in sector  $i$  by taking into account all indirect effects at work in the model. The entries of the vector  $\boldsymbol{\alpha}'\mathbf{H}$  gives a sense of how much idiosyncratic shocks occurring in one specific sector are amplified at the aggregate level (e.g., to aggregate total factor productivity). In this particular example, for instance, an idiosyncratic productivity shock occurring in sector 4 would be more amplified compared to other sectors (since  $1 > 1/3$ ).

The second frequently studied network type is the so-called “roundabout network” which we report in Figure 2.2.

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6. The illustrations are borrowed from Acemoglu et al. (2012).

To set ideas suppose again that  $N = 4$  and  $(1 - \delta) = 0.5$ , then

$$\mathbf{\Omega} = \begin{bmatrix} 0.125 & 0.125 & 0.125 & 0.125 \\ 0.125 & 0.125 & 0.125 & 0.125 \\ 0.125 & 0.125 & 0.125 & 0.125 \\ 0.125 & 0.125 & 0.125 & 0.125 \end{bmatrix}, \quad \boldsymbol{\alpha} = \begin{bmatrix} 0.25 \\ 0.25 \\ 0.25 \\ 0.25 \end{bmatrix}$$

and

$$\boldsymbol{\alpha}'\mathbf{H} \equiv \boldsymbol{\alpha}'(\mathbf{I} - \mathbf{\Omega})^{-1} = \begin{bmatrix} 0.5 & 0.5 & 0.5 & 0.5 \end{bmatrix}$$

In this example it is straightforward to see that an idiosyncratic shock would be equally amplified independently of the sector where it originates. Moreover, compared to the previous examples, idiosyncratic shocks occurring in the first three sectors would experience higher amplification (since  $0.5 > 0.3$ ) while disturbances bursting in the fourth sector would be less magnified (due to  $0.5 < 1$ ).

### 2.3 Stairway to Total Factor Productivity

To derive an expression for total factor productivity we start from the optimal sectoral input choice of a representative firm in sector  $i$

$$\max_{\{L_{i,t}, K_{i,t}, X_{i,i',t}\}} P_{i,t}Y_{i,t} - W_tL_{i,t} - Z_tK_{i,t} - \sum_{i'=1}^N P_{i',t}X_{i,i',t} \quad (2.35)$$

s.t.

$$Y_{i,t} = e^{z_{i,t}^p} \left( K_{i,t}^\gamma L_{i,t}^{1-\gamma} \right)^\delta \prod_{i'=1}^N X_{i,i',t}^{\omega_{i,i'}} \quad (2.36)$$

$$P_{i,t} = P_{i,t}(Y_{i,t}) \quad (\text{because of monopolistic competition}) \quad (2.37)$$

The sectoral FOCs of the for optimal input demands imply

$$L_{i,t} = \delta(1-\gamma) \frac{1}{\mathcal{M}_{i,t}} \frac{P_{i,t} Y_{i,t}}{W_t} = \delta(1-\gamma) \frac{1}{\mathcal{M}_{i,t}} \frac{C_t}{W_t} D_{i,t}, \quad (2.38)$$

$$K_{i,t} = \delta\gamma \frac{1}{\mathcal{M}_{i,t}} \frac{P_{i,t} Y_{i,t}}{Z_t} = \delta\gamma \frac{1}{\mathcal{M}_{i,t}} \frac{C_t}{Z_t} D_{i,t}, \quad (2.39)$$

$$X_{i',i,t} = \omega_{i',i} \frac{1}{\mathcal{M}_{i',t}} \frac{P_{i',t} Y_{i',t}}{P_{i,t}} = \tilde{\omega}_{i',i,t} \frac{D_{i',t}}{D_{i,t}} Y_{i,t}, \quad (2.40)$$

where the second equalities follow from the definition of Domar weights. The latter are defined as the ratio of the value of sectoral gross output to the sum of value added in all sectors. i.e.,  $D_{i,t} \equiv \frac{P_{i,t} Y_{i,t}}{C_t}$ . Using the expression for optimal intermediate goods (2.40) in the market clearing condition we have

$$Y_{i,t} = C_{i,t} + \sum_{i'=1}^N X_{i',i,t} = C_{i,t} + \sum_{i'=1}^N \omega_{i',i} \frac{1}{\mathcal{M}_{i',t}} \frac{P_{i',t}}{P_{i,t}} Y_{i',t}, \quad (2.41)$$

which makes it possible to express a condition pinning down the Domar weights

$$D_{i,t} = P_{i,t} \frac{C_{i,t}}{C_t} + \sum_{i'=1}^N \omega_{i',i} \frac{1}{\mathcal{M}_{i',t}} D_{i',t} = \alpha_i + \sum_{i'=1}^N \tilde{\omega}_{i',i,t} D_{i',t}, \quad (2.42)$$

or, equivalently, in stacked form

$$\mathbf{D}_t = \left( \mathbf{I} - \tilde{\Omega}_t \right)^{-1} \boldsymbol{\alpha}. \quad (2.43)$$

Let  $\kappa_{i,t}^\ell := L_{i,t}/L_t$  and  $\kappa_{i,t}^k := K_{i,t}/K_t$  denote the share of sectoral labor over total labor and the share of sectoral capital over total capital, respectively. We can use the previous

equations to write these shares in terms of the Domar weights,

$$\begin{aligned}\kappa_{i,t}^\ell &= \frac{\delta(1-\gamma) \frac{1}{\mathcal{M}_{i,t}} \frac{C_t}{W_t} D_{i,t}}{\sum_{i'=1}^N \delta(1-\gamma) \frac{1}{\mathcal{M}_{i',t}} \frac{C_t}{W_t} D_{i',t}} \\ &= \frac{\frac{1}{\mathcal{M}_{i,t}} D_{i,t}}{\sum_{i'=1}^N \frac{1}{\mathcal{M}_{i',t}} D_{i',t}}\end{aligned}\tag{2.44}$$

and analogously,

$$\kappa_{i,t}^k = \frac{\frac{1}{\mathcal{M}_{i,t}} D_{i,t}}{\sum_{i'=1}^N \frac{1}{\mathcal{M}_{i',t}} D_{i',t}}.\tag{2.45}$$

Given these shares, we can express sectoral labor and capital in terms of the aggregate variables,  $L_{i,t} = \kappa_{i,t}^\ell L_t$  and  $K_{i,t} = \kappa_{i,t}^k K_t$ , so we can write sectoral output as

$$\begin{aligned}Y_{i,t} &= e^{z_{i,t}^p} (L_{i,t})^{\delta(1-\gamma)} (K_{i,t})^{\delta\gamma} \prod_{i'=1}^N X_{i,i',t}^{\omega_{i,i'}} \\ &= e^{z_{i,t}^p} \left(\kappa_{i,t}^\ell L_t\right)^{\delta(1-\gamma)} \left(\kappa_{i,t}^k K_t\right)^{\delta\gamma} \prod_{i'=1}^N \left(\tilde{\omega}_{i,i',t} \frac{D_{i,t}}{D_{i',t}} Y_{i',t}\right)^{\omega_{i,i'}}\end{aligned}$$

or equivalently, in log terms, and using the fact that  $\kappa_{i,t}^\ell = \kappa_{i,t}^k = \kappa_{i,t}$

$$y_{i,t} = \underbrace{\left[ \delta \log(\kappa_{i,t}) + \sum_{i'=1}^N \omega_{i,i'} \log\left(\tilde{\omega}_{i,i',t} \frac{D_{i,t}}{D_{i',t}}\right) \right]}_{:=a_{i,t}} + \delta(1-\gamma) \ell_t + \delta\gamma k_t + \sum_{i'=1}^N \omega_{i,i'} y_{i',t} + z_{i,t}^p.\tag{2.46}$$

In stacked form, this reads

$$\mathbf{y}_t = (\mathbf{I} - \mathbf{\Omega})^{-1} (\mathbf{a}_t + \mathbf{z}_t^p + \delta(1-\gamma) \mathbf{1}\ell_t + \delta\gamma \mathbf{1}k_t).\tag{2.47}$$

Next, we express sectoral output as a function of aggregate value-added production,  $C_t$ .

Using the Domar weights definition we obtain

$$\begin{aligned}
c_t &= \boldsymbol{\alpha}' (\mathbf{y}_t + \mathbf{p}_t - \mathbf{d}_t) \\
&= \boldsymbol{\alpha}' \left[ (\mathbf{I} - \boldsymbol{\Omega})^{-1} \mathbf{a}_t + \mathbf{p}_t - \mathbf{d}_t + (\mathbf{I} - \boldsymbol{\Omega})^{-1} \mathbf{z}_t^p \right] + \delta (1 - \gamma) \boldsymbol{\alpha}' (\mathbf{I} - \boldsymbol{\Omega})^{-1} \mathbf{1} \ell_t \\
&\quad + \delta \gamma \boldsymbol{\alpha}' (\mathbf{I} - \boldsymbol{\Omega})^{-1} \mathbf{1} k_t
\end{aligned}$$

It can be shown that the term  $\boldsymbol{\alpha}' (\mathbf{p}_t - \mathbf{d}_t)$  is actually equal to  $(\mathbf{I} - \mathbb{X}')^{-1} \mathbb{X}' \mathbf{z}_t^{cp}$ . Then, aggregate value-added production can be expressed as

$$C_t = TFP_t \cdot L_t^{\alpha_{a,\ell}} \cdot K_t^{\alpha_{a,k}}$$

where

$$\begin{aligned}
\alpha_{a,\ell} &= (1 - \gamma) \\
\alpha_{a,k} &= \gamma \\
TFP_t &= \exp \left\{ \boldsymbol{\alpha}' \mathbf{H} [\mathbf{a}_t + \mathbf{z}_t^p] + \boldsymbol{\alpha}' (\mathbf{I} - \mathbb{X}')^{-1} \mathbb{X}' \mathbf{z}_t^{cp} \right\} \\
\mathbf{H} &:= (\mathbf{I} - \boldsymbol{\Omega})^{-1}
\end{aligned} \tag{2.48}$$

A few comments about this result. First, starting from a sectoral CRS value-added production we just showed that the aggregate value-added production also exhibits CRS. Second, the aggregate measure of TFP is composed of three terms (i)  $\mathbf{a}_t$ , a vector of weighted markup indices per sector, (ii)  $\mathbf{z}_t^p$ , the vector of productivity shocks and (iii)  $\mathbf{z}_t^{cp}$ , the vector of cost-push shocks. Last, the first two terms,  $\mathbf{a}_t$  and  $\mathbf{z}_t^p$ , depend on the network structure through the consumption index weighted Leontief matrix  $\boldsymbol{\alpha}' \mathbf{H}$  (illustrated in Section 2.2.6), which amplifies their effects.

## 2.4 Static and Dynamic Determinants of TFP

We study how the steady state level and the dynamic responses of TFP are influenced by (i) the type of production networks, (ii) the degree of monopolistic competition and (iii) price stickiness. In all simulations, the economy is calibrated at a quarterly frequency to the U.S. economy's 14 main sectors and results are reported along with those for the posterchild

theoretical examples of the star and of the roundabout network. As to the latter, we construct the I-O matrix  $\Omega$ , depicted in Figure 2.3, using the summary-level BEA 2015<sup>7</sup> “make” and “use” tables (excluding the government sector) according to the procedure outlined in Pasten et al. (2016a).

The consumption shares  $\alpha$  for the 14-sectors U.S. economy are obtained as the ratio of a sector’s personal consumption expenditures (as reported in the “use” tables) to the total aggregated level. We use the latter as weights to obtain the sectoral degrees of price stickiness as a weighted sum of the price stickiness parameters computed by Pasten et al. (2016a) at the more granular 350 sectors level. The same price stickiness parameters are used for the theoretical network types (star and roundabout) so as to facilitate comparison. Finally, the deep parameters of the model are set to standard values used in the DSGE literature (see Galí (2008)), as reported in Table 2.1.

We start by inspecting the determinants of TFP levels by tracking how steady state TFP varies with the degree of monopolistic competition prevailing in the economy. We do so by letting the steady state gross markup  $\mathcal{M}_i = \mathcal{M} = \left(\frac{\epsilon}{\epsilon-1} - 1\right)$  range from 10% to 50% which respectively correspond to  $\epsilon = 11$  and  $\epsilon = 3$ , the highest and lowest values for elasticities of substitution across goods documented by Nakamura and Steinsson (2010b). Moreover, we consider four production network cases, namely (i) no network, (ii) star network, (iii) roundabout network, (iv) main 14 U.S. economy sectors network, as well as two intermediate goods shares (i)  $(1 - \delta) = 0.5$  and (ii)  $(1 - \delta) = 0.6$ . We will pay special attention to the case of  $\delta = 0.5$  since according to Christiano (2015) a typical firm sells about one-half of its output to other firms and materials purchases from other firms account for roughly half of the firm’s input costs.

Figure 2.4 shows the percentage deviation of steady state TFP from its frictionless level<sup>8</sup> as a function of the economy’s average gross markup.

Four results stand out. First, for a given level of average price markup, more connected networks amplify inefficiencies, reducing TFP. Second, for a given network, the loss in TFP

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7. The calibration does not change substantially if previous years are considered.

8. The latter could be obtained if, e.g., an employment subsidy was in place. In this case  $(1 - \tau_i) = 1/\mathcal{M}_i = \frac{\epsilon-1}{\epsilon}$  and monopolistic competition would not have any impact on steady state TFP.

produced by monopolistic competition can vary steeply with the average markup. Third, the inefficiency introduced by the presence of monopolistic competition is stronger the larger the share of intermediate goods in the economy. This is because, in this model, monopolistic competition reduces TFP by inducing an inefficiently low level of intermediate goods trade. Thus, the higher the intermediate goods share in production the more sub-optimal is the production of the latter and the less efficient the economy. Clearly, in the absence of production networks this channel is inactive and monopolistic competition does not influence TFP. Last, for the 14-sectors calibrated U.S. economy with  $\delta = 0.5$ , even a relatively small average price markup of 15% over marginal costs corresponds to a level of TFP on average 25% lower than the one obtained under perfect competition.

This exercise is intended as an illustration of the channels playing a role in influencing TFP levels. For instance, the model could be calibrated to study this type of distortion within and/or across countries in different periods of time. In this context, it is important to note that estimations of average markups vary quite a lot, sometimes even exceeding 50% (Hall, 1988 estimates an average markup of 180% at the one-digit level). This not only highlights the importance of good data for markups but most importantly suggests that sizeable differences in incomes across countries could potentially emerge from different degrees of monopolistic competition.

Moving to the dynamic determinants of TFP, the parameterization of the shocks' parameters is reported in Table 2.2. In order to make the IRFs comparable we set the autocorrelation to 0.9 and the annualized standard deviation to 1% on an annual basis for all shocks.

One of our main findings is that the response of TFP to a monetary and a cost-push shock closely tracks the response of markups to these disturbances. In particular, as stressed above, whenever markups increase then the inefficiency in the economy increases too since firms use a sub-optimal low level of intermediate inputs and thus produce a level of output which is lower than in the frictionless case. Prior to showing the impulse responses we can thus predict how TFP will move by inspecting what happens to markups. First, in response to a positive monetary policy shock we have that, due to the presence of price stickiness, the decrease in prices does not compensate the decrease in nominal marginal costs (i.e., real

marginal costs decrease) so that markups rise and, thus, TFP decreases:

$$\uparrow \mathcal{M} = \frac{P \downarrow}{MC \Downarrow}, \quad \text{“Short Run”}: TFP \downarrow$$

Second, following a positive price markup shock real marginal costs decrease, markups increase and TFP thus decreases:

$$\uparrow \mathcal{M} = \frac{P \uparrow}{MC \Downarrow}, \quad \text{“Short Run”}: TFP \downarrow$$

Last, a positive technology shock engineers a drop in real marginal costs which corresponds to a rise in markups:

$$\uparrow \mathcal{M} = \frac{P \downarrow}{MC \Downarrow}, \quad \text{“Short Run”}: TFP \downarrow$$

This increase in markups is, however, contrasted by a direct increase in productivity. For a technology shock this pure productivity channel turns out to be the quantitatively most important one. Thus, positive productivity shocks in this economy exert a positive effect on TFP. In all cases markups eventually revert to their steady state levels so that shocks affect TFP only temporarily.

In the special case of no networks and CRS we have  $\mathbf{\Omega} = \mathbf{0}$ ,  $\delta = 1$  and  $\mathbf{X} = \mathbf{0}$ . In this case, it is possible to show that  $\hat{\mathbf{a}}_t = \mathbf{0}$  which means that neither monetary policy nor cost-push shocks would have an effect on aggregate TFP. It is straightforward to see why this is the case. In the presence of no production networks the goods market clearing condition reads  $Y_{i,t} = C_{i,t}$ . That is, gross sectoral output is equal to net sectoral output and  $Y_{i,t} = e^{z_{i,t}^p} \left( K_{i,t}^\gamma L_{i,t}^{1-\gamma} \right)^\delta$  and TFP is hence composed of the pure productivity shock only.

These mechanisms become evident in Figure 2.5 which illustrates the impulse response of TFP to a monetary policy shocks for different network types and for the 14-sector U.S. economy calibrated heterogeneous price stickiness (from a minimum of 0.2834 in the “agriculture, forestry, fishing, and hunting” sector to a maximum of 0.9722 in the “other services, except government” sector). Even though in New Keynesian models featuring production networks it is found that monetary policy shocks have real effects independently of the presence and

the type of intermediate goods trade across sectors (see Pasten et al., 2016a), measured TFP does not move in the absence of production networks. In the network economies, in contrast, TFP is negatively affected by the monetary policy shock due to its negative impact on markups. In particular, a 1% increase in the nominal interest rate on an annual basis leads to a drop in TFP from roughly 3.5% in the calibrated U.S. economy and to around 3% in the star and roundabout economy. We investigate the role of price stickiness in Figure 2.6 where we consider three different cases: (i) heterogeneous price stickiness as parameterized in the baseline, (ii) heterogeneous and low price stickiness (i.e., the baseline  $\theta$  is multiplied by 0.1) and, finally, (iii) homogeneous price stickiness<sup>9</sup> ( $\theta_i = \theta = 0.8199$ ,  $\forall i$  which is an average of case (i)). Consistently with previous findings of the effect of heterogeneous price stickiness on real effects, homogeneous price stickiness tends to have a smaller effect on TFP compared to the heterogeneous counterpart. Moreover, in keeping in line with the standard New Keynesian model, lower price stickiness dampens the effects of monetary policy shocks. Finally, only in the case of heterogeneous and medium-high price stickiness do network economies feature substantial and different TFP responses. Indeed, in the case of homogeneous price stickiness the IRFs do not vary across network types and in the heterogeneous but low price stickiness case they are almost undistinguishable.

The effect of a common and an idiosyncratic productivity shock originating in the manufacturing sector (which features a price stickiness of  $\theta_5 = 0.5245$ ) are shown in Figure 2.7 and Figure 2.8 respectively. Several results are worth commenting on. First, the productivity shock is the only shock to which TFP reacts in the absence of production networks. This is actually a “true” technology shock, so it is by construction positively correlated with aggregate TFP. We can see the effect of the network amplification mechanism at work: Economies with networks present a bigger impact response. In terms of magnitudes, a 1% common productivity shock on an annual basis leads to an average 2.25% increase in TFP for the network economies and to a 1% increase in the no networks case. The idiosyncratic productivity shock produces smaller effects, ranging from less than 0.1% in the absence of networks, 0.2% in the calibrated U.S. economy, 0.1% in the roundabout economy to a bit

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9. The homogeneous price stickiness parameter corresponds to the consumption shares weighted average of the (heterogeneous) sectoral degrees of price stickiness.

less than 0.45% in the star economy. In Figure 2.9 we compute the same IRFs in an economy with 50 sectors, with price stickiness parameters ranging in an equispaced interval from 0.5 to 0.8. In this case, the importance of idiosyncratic shocks tends to decrease. This is true for both the no networks and for the roundabout economy. In the case of the star economy, the idiosyncratic shock occurs in the central sector of the economy so that the contribution of this idiosyncratic shock doesn't go away at the aggregate level. This is related to the outdegree of the central sector in this economy (see Acemoglu et al., 2012) and reflected in the entry of the manufacturing sector being the biggest one in magnitude in the amplification vector  $\alpha'H$  (this is by construction since we make this sector the central one in the star economy), along the lines of the discussion in Section 2.2.6.

Another interesting piece of evidence comes from the impulse responses to a common and to an idiosyncratic cost-push shock originating in the manufacturing sector, illustrated in Figure 2.10 and Figure 2.11 respectively. Again, TFP doesn't move in the absence of intermediate goods trade across sectors. In the network economies however, this shock has a negative effect on TFP since it leads to a direct increase in markups which in turn make the economy less efficient. In the case of a common shock the TFP decrease is of about 0.1%, 0.5% and 0.7% for the calibrated, roundabout and star economy respectively. In the idiosyncratic case the magnitudes are small for the roundabout and calibrated case, being around 0.1%, whereas of non-negligible magnitude for the star network which features a TFP drop of roughly 0.02% after one and two quarters. The effects of an idiosyncratic shocks in a roundabout economy converge to zero as  $N$  increases while they are slightly milder for the star network, as becomes evident from Figure 2.12.

Finally, in Appendix 2.A, we explore how the IRFs vary according to (i) the elasticity of substitution  $\epsilon$  (and, thus, average markup in the economy), (ii) the share of intermediate goods  $(1 - \delta)$  and (iii) the degree of price stickiness. As to the first, we find that the milder is monopolistic competition, the more dampened is the drop in TFP in the case of the roundabout and star network and the more pronounced is an increase in TFP in the calibrated 14 sectors U.S. economy following a cost-push shocks. The impulse response of TFP to other shocks is barely affected when varying  $\epsilon$ . As to the second, the higher is the intermediate goods share  $1 - \delta$ , the stronger is the impact on TFP. These two sensitivity

checks thus provide a picture which is consistent with the results and arguments presented for steady state TFP. As to the last, a higher degree of price stickiness is associated with a milder effect of productivity shocks for price markup shocks to less negative and, in some cases, even positive responses.

## 2.5 Conclusions

In this paper we have provided a framework to quantify the effect of monopolistic competition, sticky prices and production networks on aggregate TFP.

As to its static dimension, we find that for a given level of average price markup, more connected networks amplify inefficiencies, reducing steady state TFP. Also, for a given network, the loss in TFP produced by monopolistic competition can vary steeply depending on the average markup.

Our model also sheds a light on the dynamic behavior of TFP. With no networks, TFP only varies with productivity shocks whilst in the presence of networks, TFP varies with all the types of shocks introduced here. Contractionary monetary policy and positive cost-push shocks decrease TFP. The presence of networks can amplify idiosyncratic productivity shocks so as to potentially induce large aggregate effects. Price-markup shocks decrease TFP, especially if they occur in sectors with large out-degrees. Idiosyncratic price-markup shocks can have large aggregate effects.

Our future work involves different tasks. First, we can use this model to decompose the main factors of TFP changes in the U.S. economy. This would first involve constructing a correct measure of sectoral price gaps. Our framework could also be used to explain the differences in TFP levels across countries, by quantifying the relative importance of monopolistic competition and production networks in each economy. As to business cycle TFP movements, we plan to analyze whether our theoretical prediction that contractionary monetary policy shocks have a negative impact on aggregate TFP also holds in the data.

## 2.6 Figures and Tables

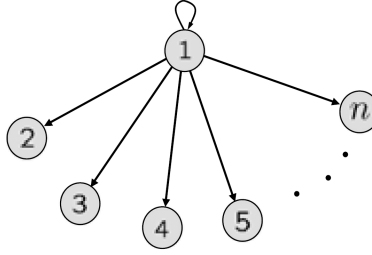


Figure 2.1: Star Network. One sector supplies intermediate goods to the whole economy.

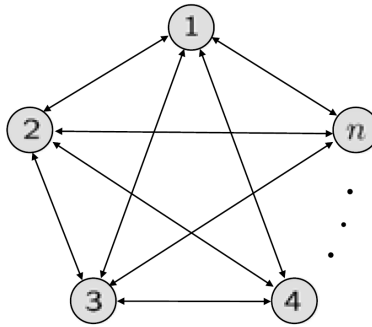


Figure 2.2: Roundabout Network. Every sector supplies intermediate goods to the other sectors in equal amounts.

Table 2.1: Deep Parameters Parameterization

$\beta$	Subjective Discount Factor	0.99
$\delta$	<b>Labor and Capital Share</b>	<b>0.5</b>
$\delta^k$	Capital Depreciation	0.025
$\gamma$	Capital Coefficient	1/6
$\sigma$	Inverse Intertemporal Elasticity of Substitution	1
$\epsilon$	<b>Elasticity of Substitution Between Goods</b>	<b>9</b>
$\varphi$	Inverse Frisch Elasticity of Labor Supply	5
$\theta$	<b>(Heterogeneous) Sectoral Price Stickiness</b>	<b>[0.2834, 0.9722]</b>
$\phi_\pi$	Inflation Taylor Rule Coefficient	1.5
$\phi_c$	Value Added GDP Taylor Rule Coefficient	0.5/4

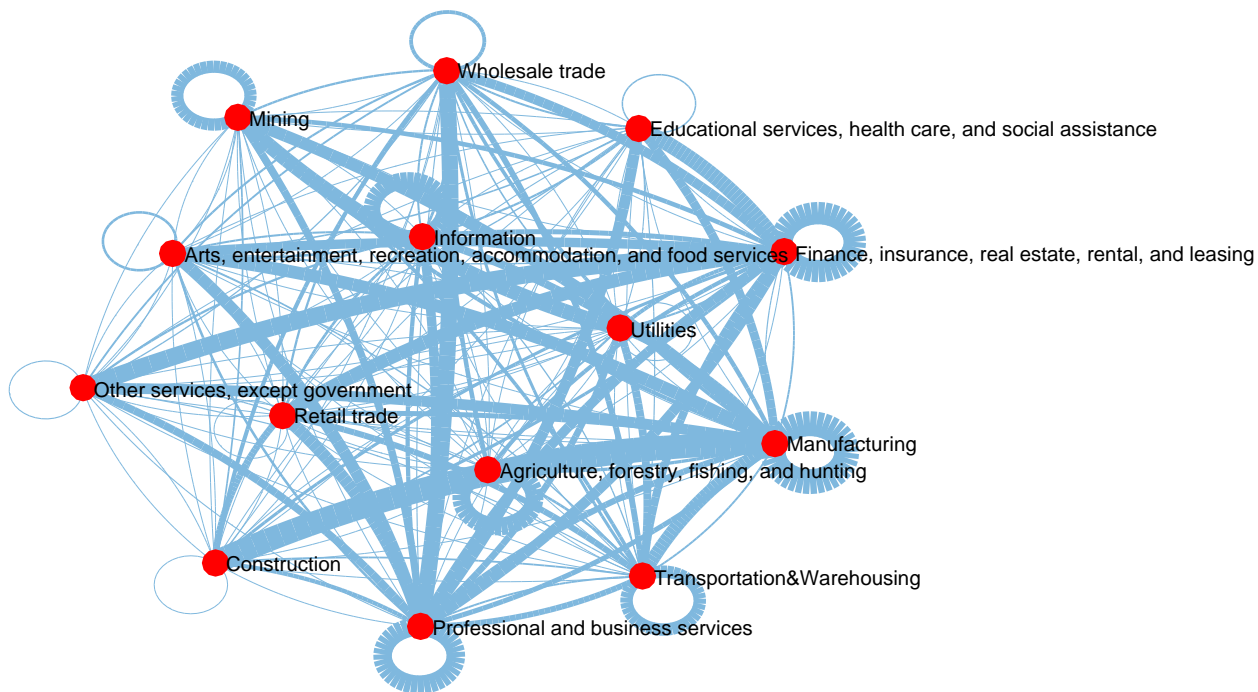


Figure 2.3: Input-Output Matrix, BEA 2002, U.S. Economy's 14 Main Sectors.

Table 2.2: **Shocks' Parameters Parameterization**

Autocorrelation of Shocks	0.9
Standard Deviation of Shocks (= 1% on annual basis)	0.01/12

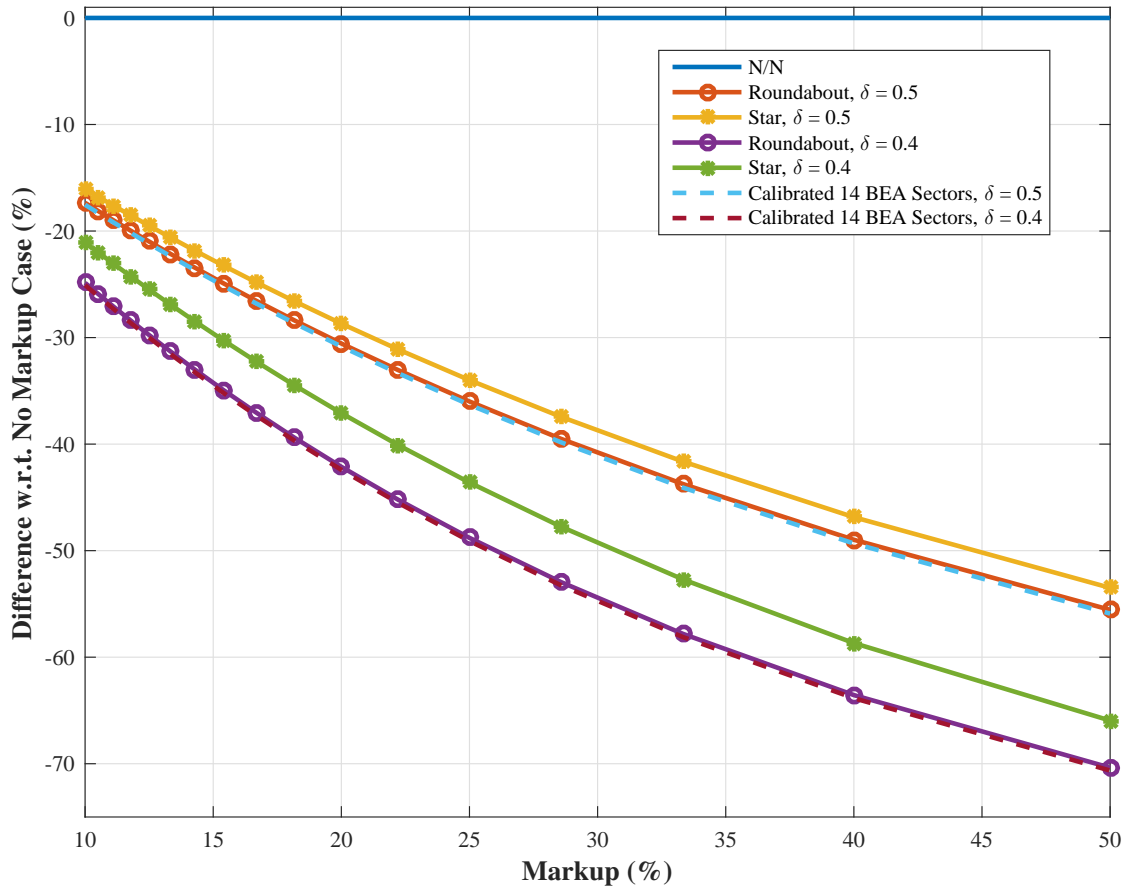


Figure 2.4: Percentage Deviation of Steady State TFP From Frictionless Level.

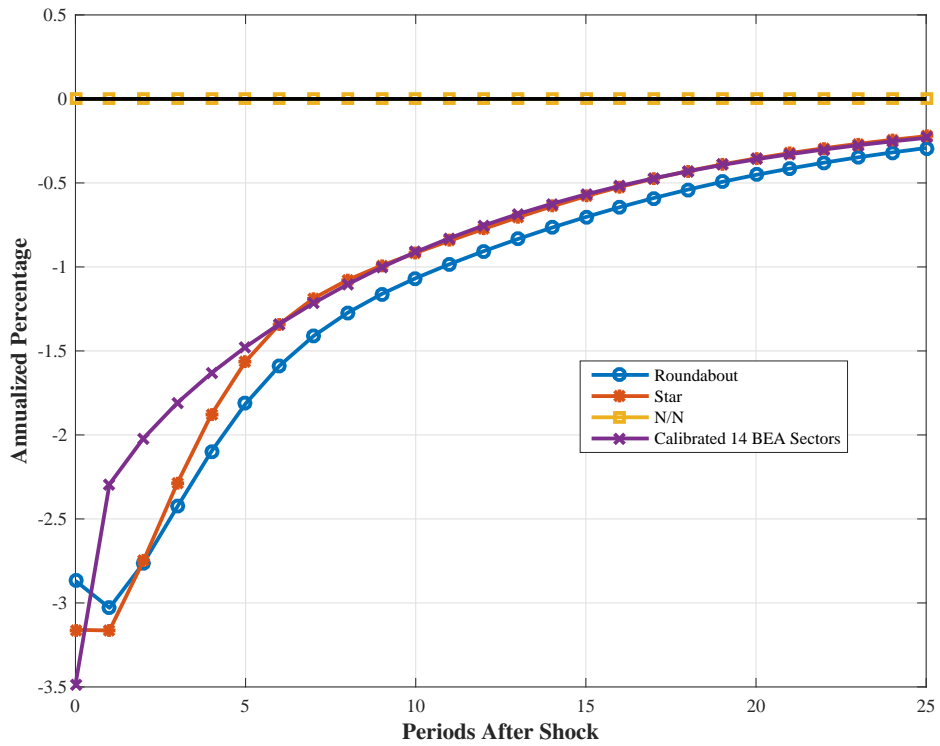


Figure 2.5: IRF to Monetary Policy Shock.

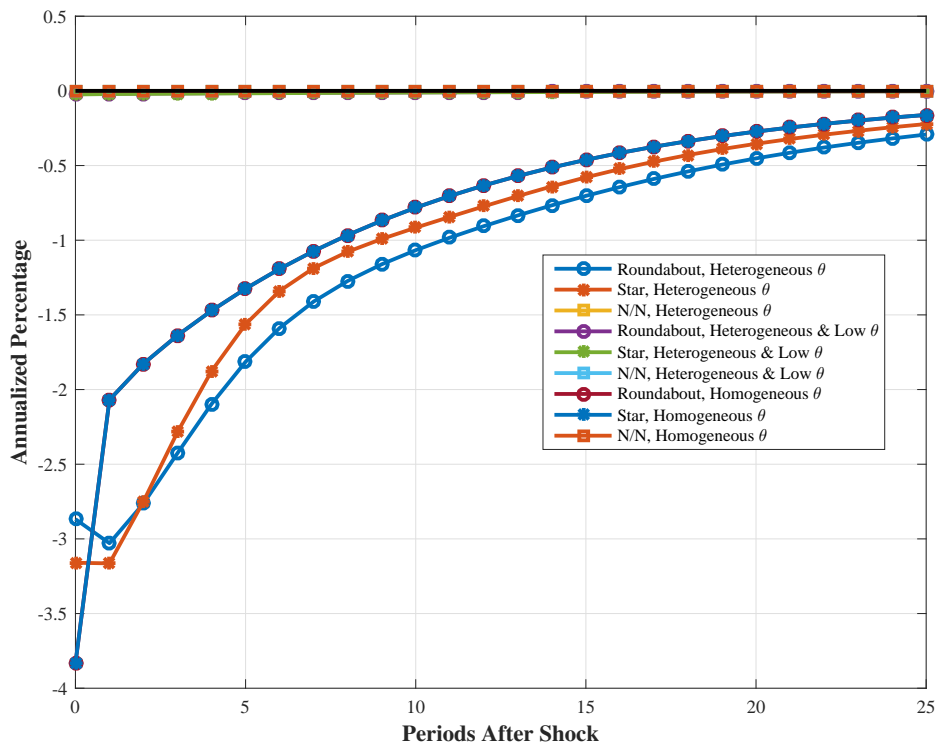


Figure 2.6: IRF to Monetary Policy Shock – Different  $\theta$ .

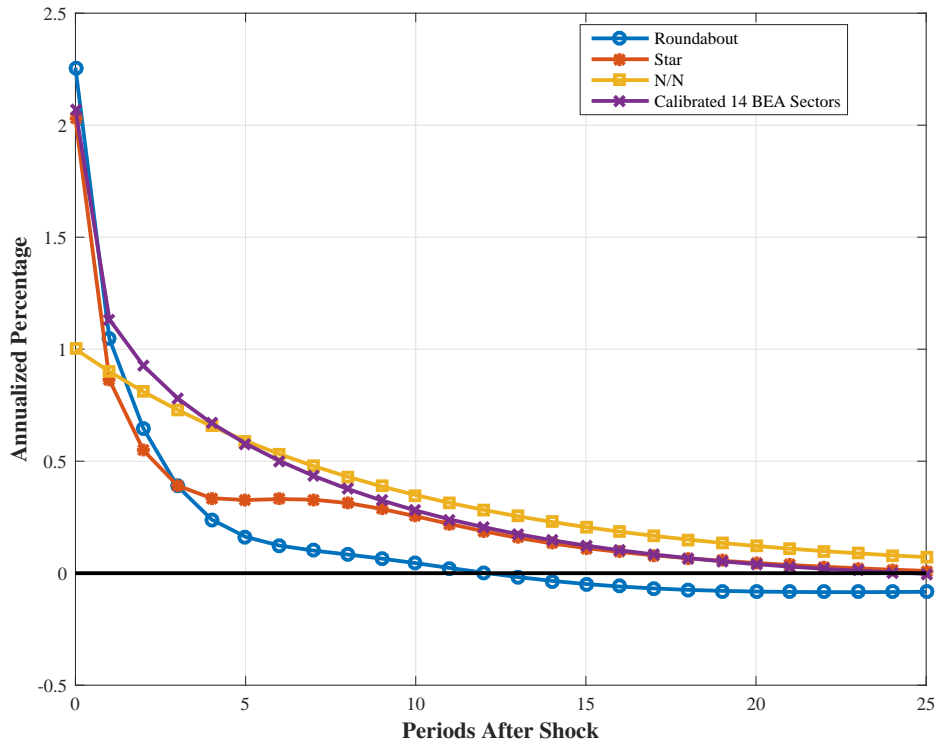


Figure 2.7: IRF to Common Productivity Shock.

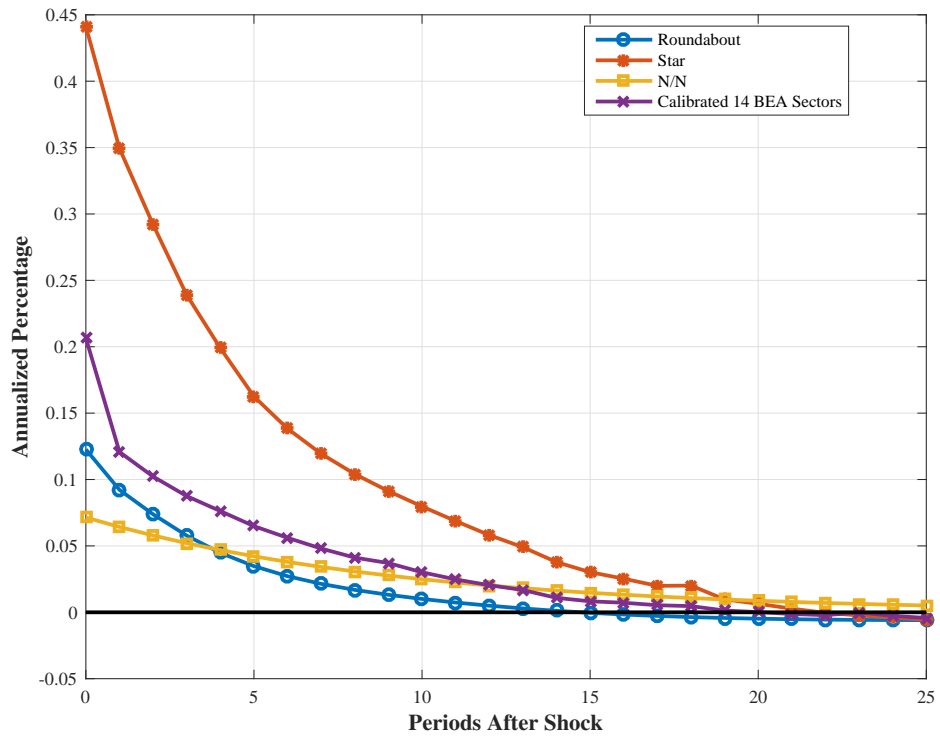


Figure 2.8: IRF to Idiosyncratic Productivity Shock.

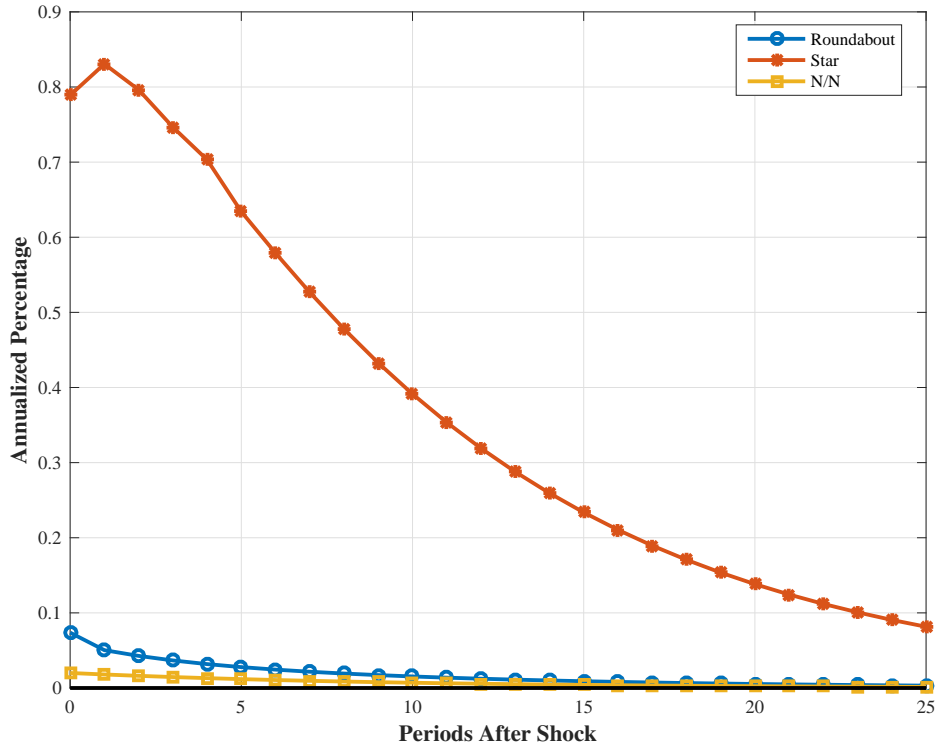


Figure 2.9: IRF to Idiosyncratic Productivity Shock.  $N = 50$  Sectors.

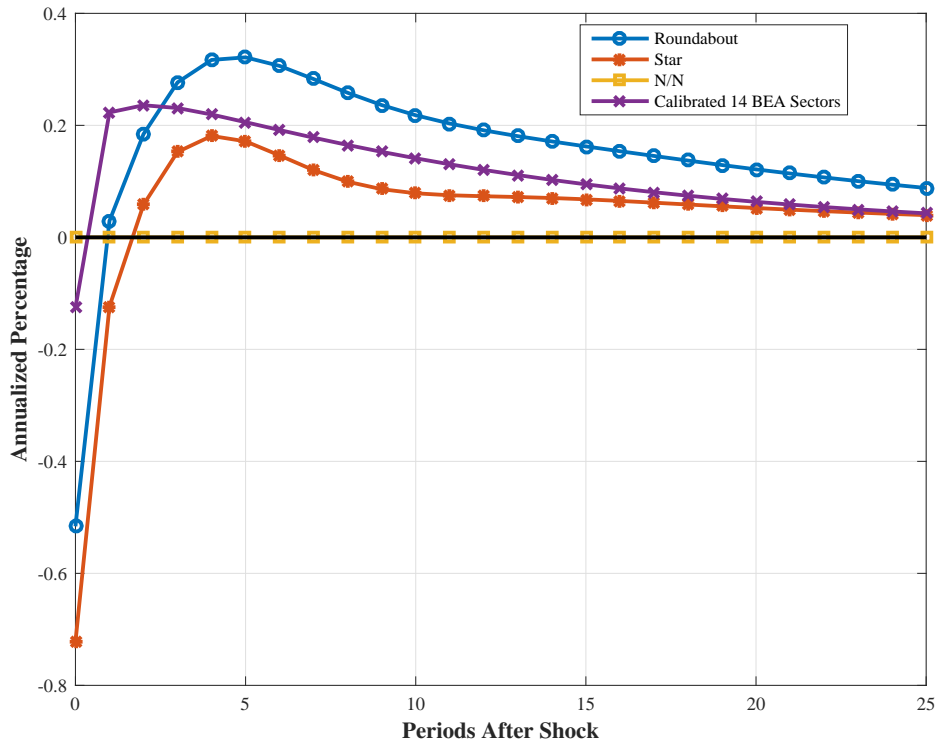


Figure 2.10: IRF to Common Price-Markup Shock.

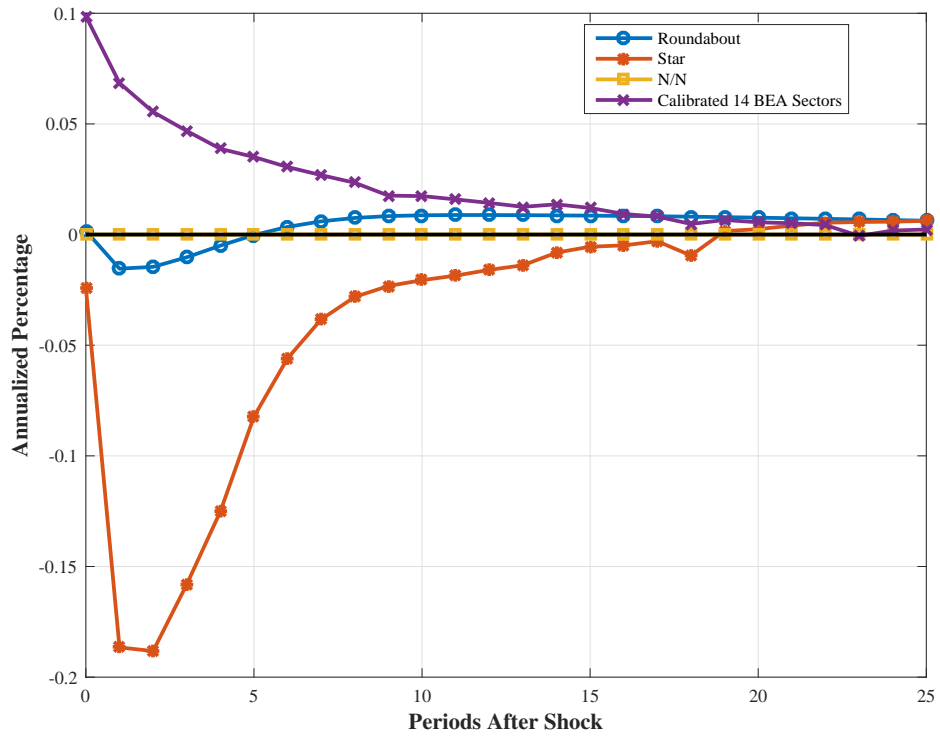


Figure 2.11: IRF to Idiosyncratic Price-Markup Shock.

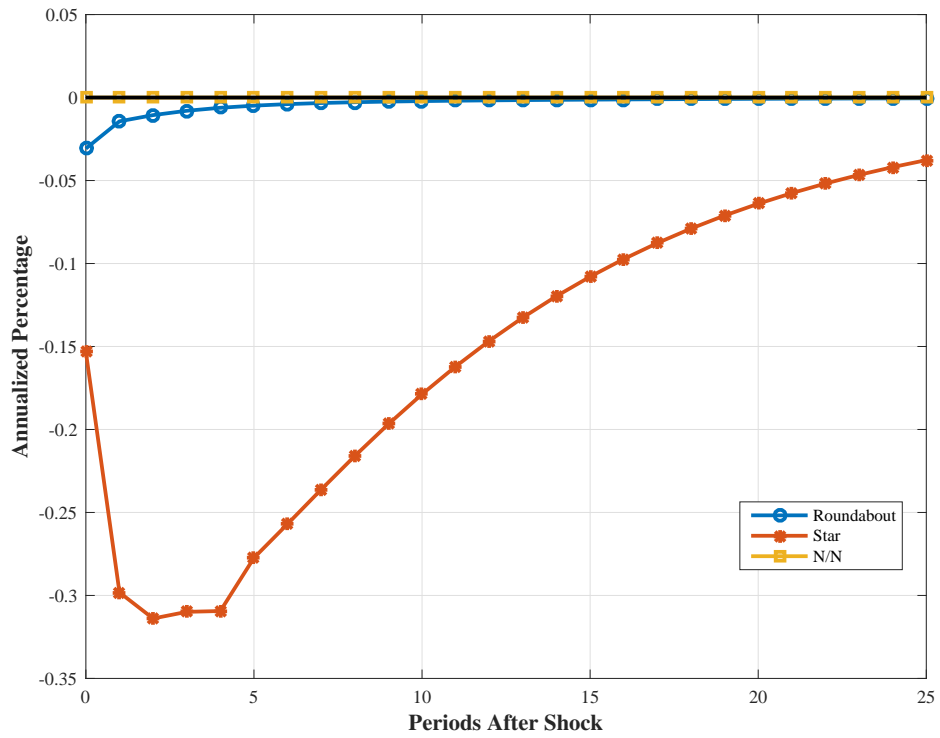


Figure 2.12: IRF to Idiosyncratic Price-Markup Shock.  $N = 50$  Sectors.

## 2.A Sensitivity Analysis

We perform three sensitivity checks. First, we analyze how the elasticity of substitution affects the response of TFP to common and idiosyncratic cost-push shocks from Figure 2.13 to 2.18. Second, from Figure 2.19 to 2.23, we study how the IRFs are affected by varying the share of intermediate goods in the production function. Finally, we explore how results are affected by varying the degree of price stickiness in the simulation exercises. More specifically, in Figures 2.24 to 2.27 we show how the IRFs change if the price stickiness parameters across sectors are (i) heterogeneous, (ii) heterogeneous and low, (iii) homogeneous.

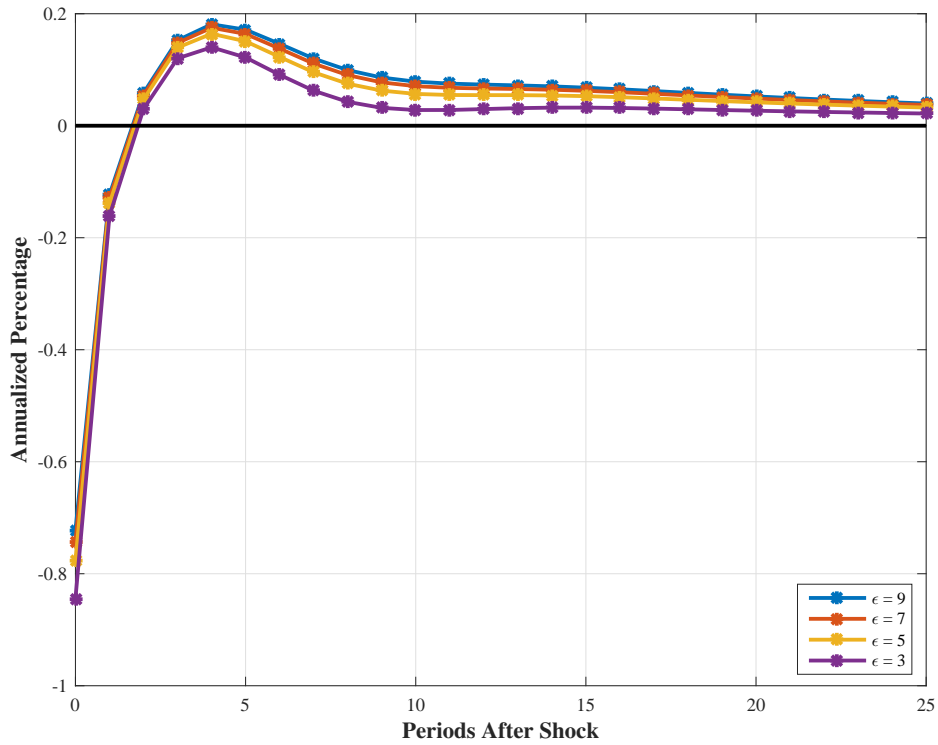


Figure 2.13: IRF to Common Price-Markup Shock, Star Economy. Varying  $\epsilon$ .

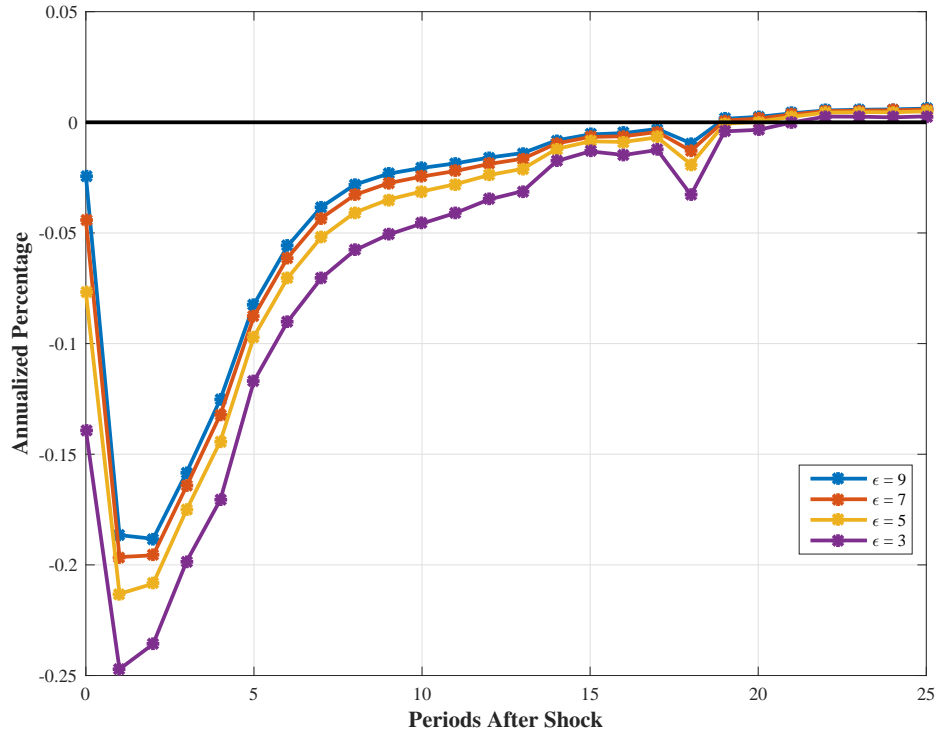


Figure 2.14: IRF to Idiosyncratic Price-Markup Shock, Star Economy. Varying  $\epsilon$ .

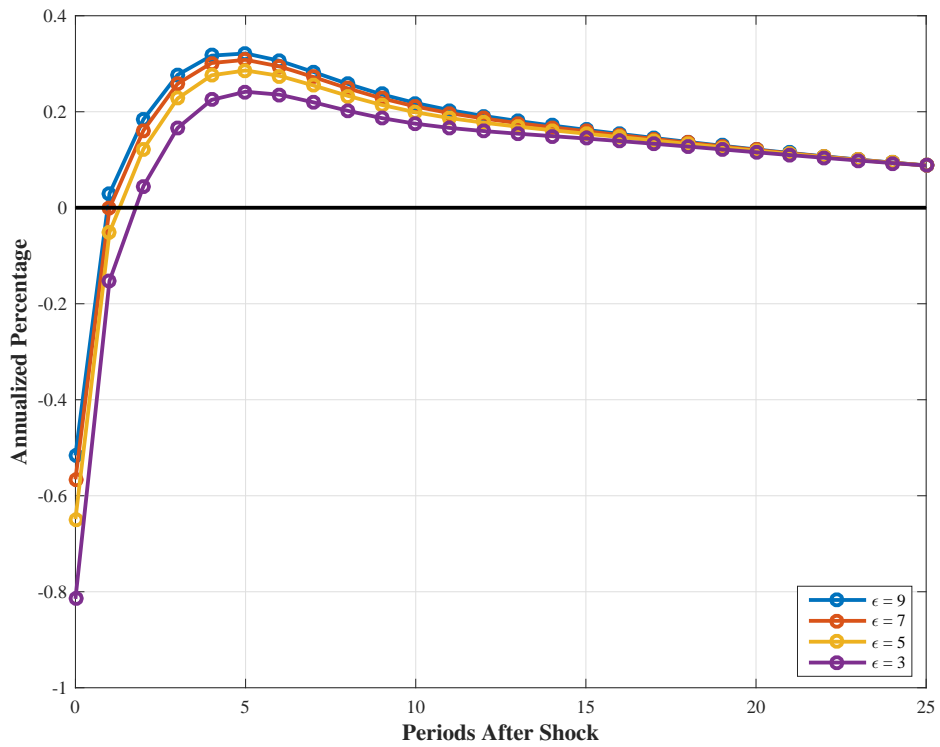


Figure 2.15: IRF to Common Price-Markup Shock, Roundabout Economy. Varying  $\epsilon$ .

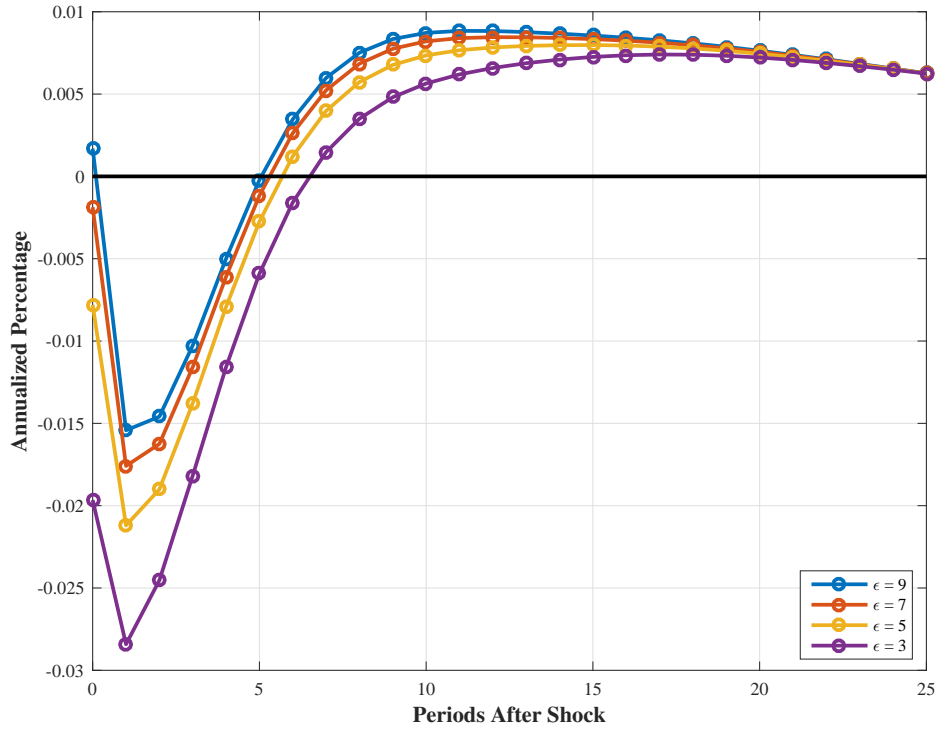


Figure 2.16: IRF to Idiosyncratic Price-Markup Shock, Roundabout Economy. Varying  $\epsilon$ .

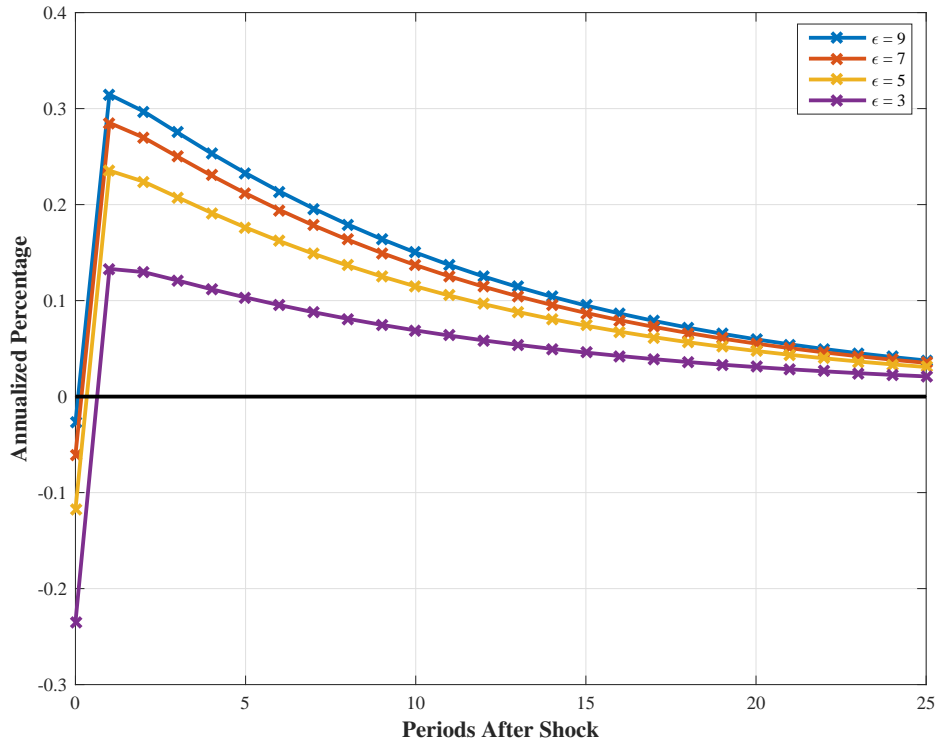


Figure 2.17: IRF to Common Price-Markup Shock, 14 Sectors Calibrated U.S. Economy. Varying  $\epsilon$ .

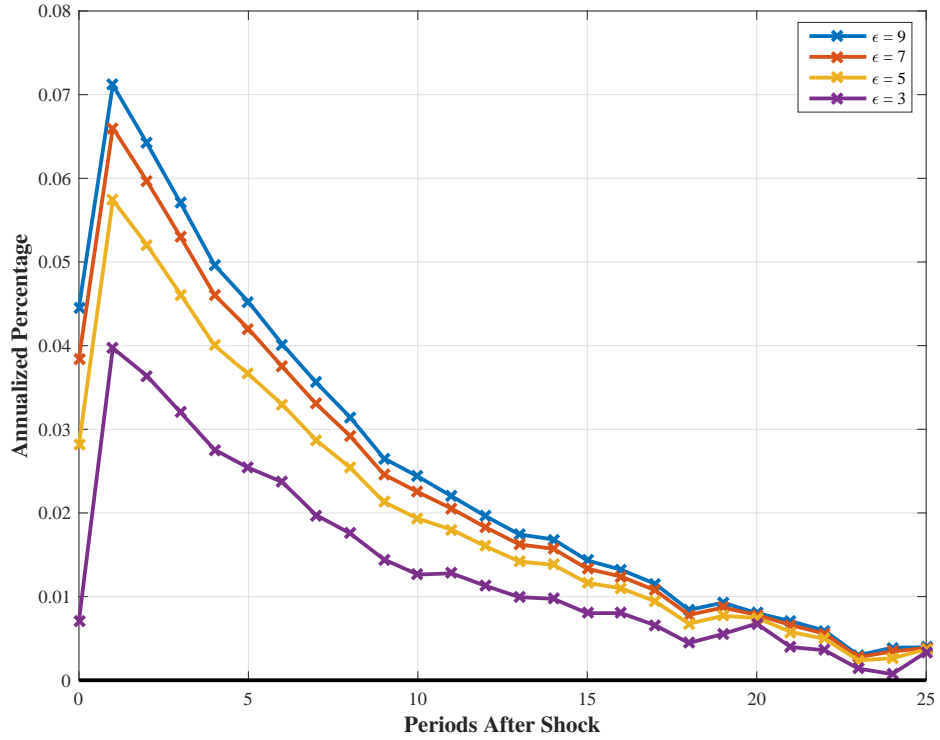


Figure 2.18: IRF to Idiosyncratic Price-Markup Shock, 14 Sectors Calibrated U.S. Economy. Varying  $\epsilon$ .

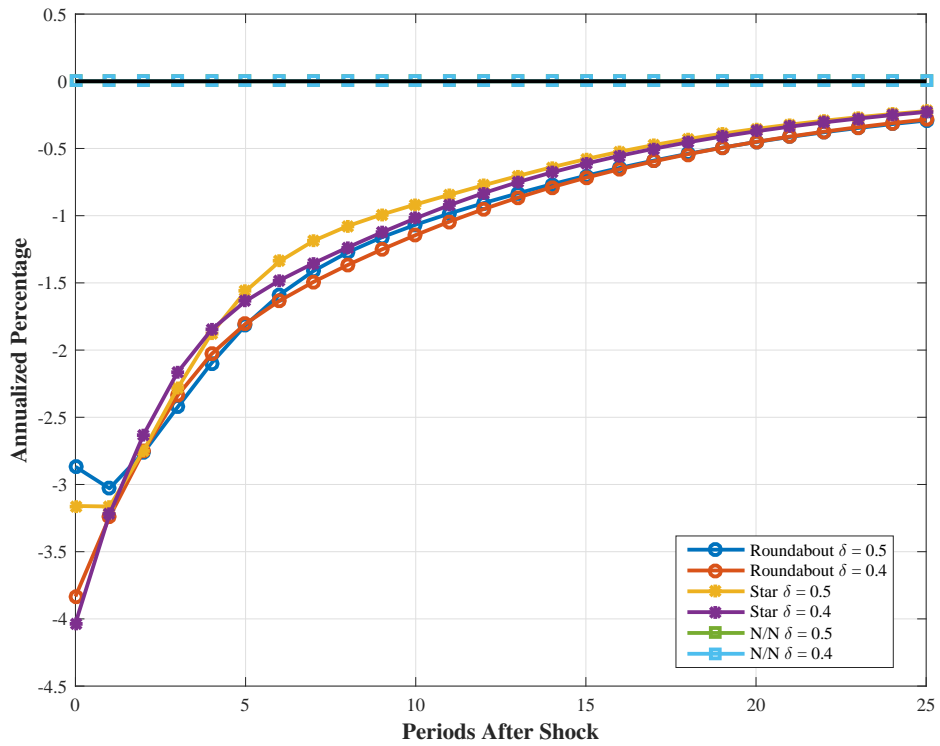


Figure 2.19: IRF to Monetary Policy Shock. Varying Intermediate Goods Shares.

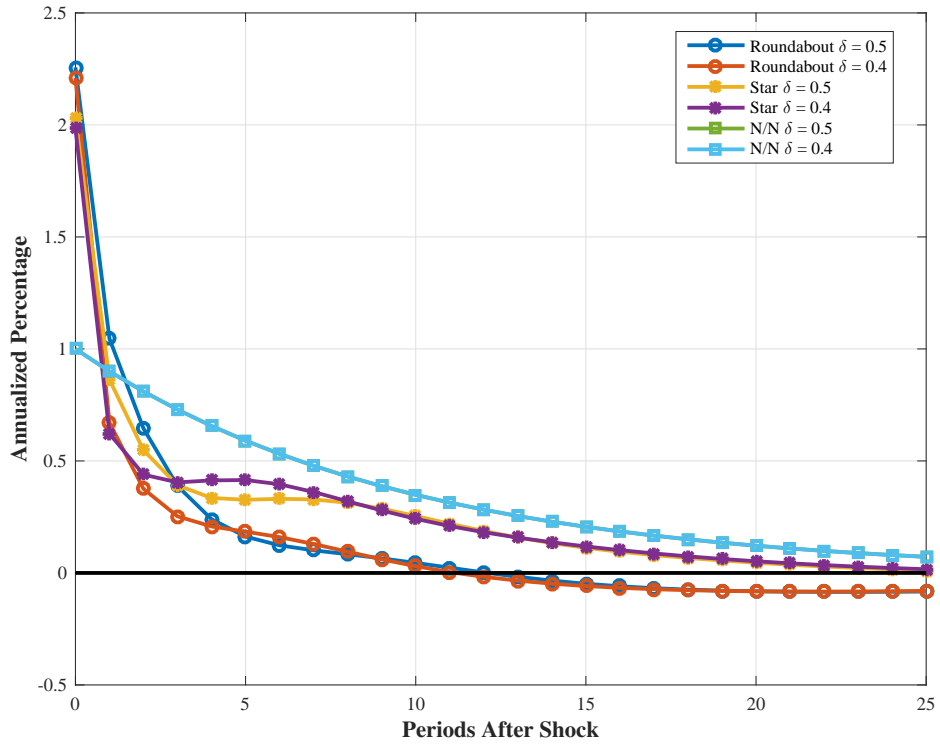


Figure 2.20: IRF to Common Productivity Shock. Varying Intermediate Goods Shares.

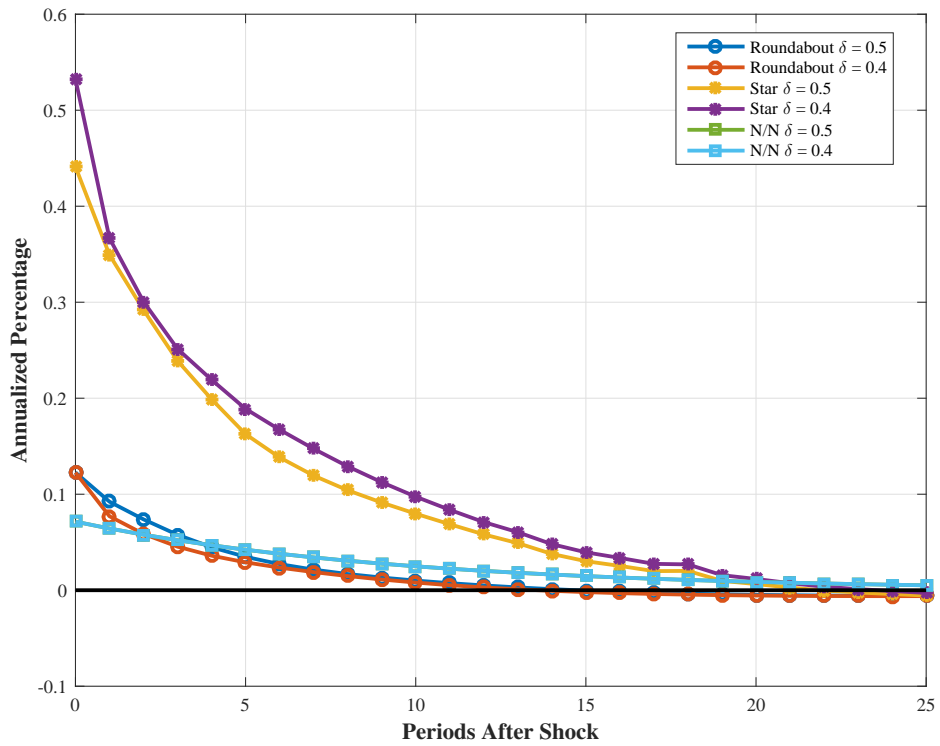


Figure 2.21: IRF to Idiosyncratic Productivity Shock. Varying Intermediate Goods Shares.

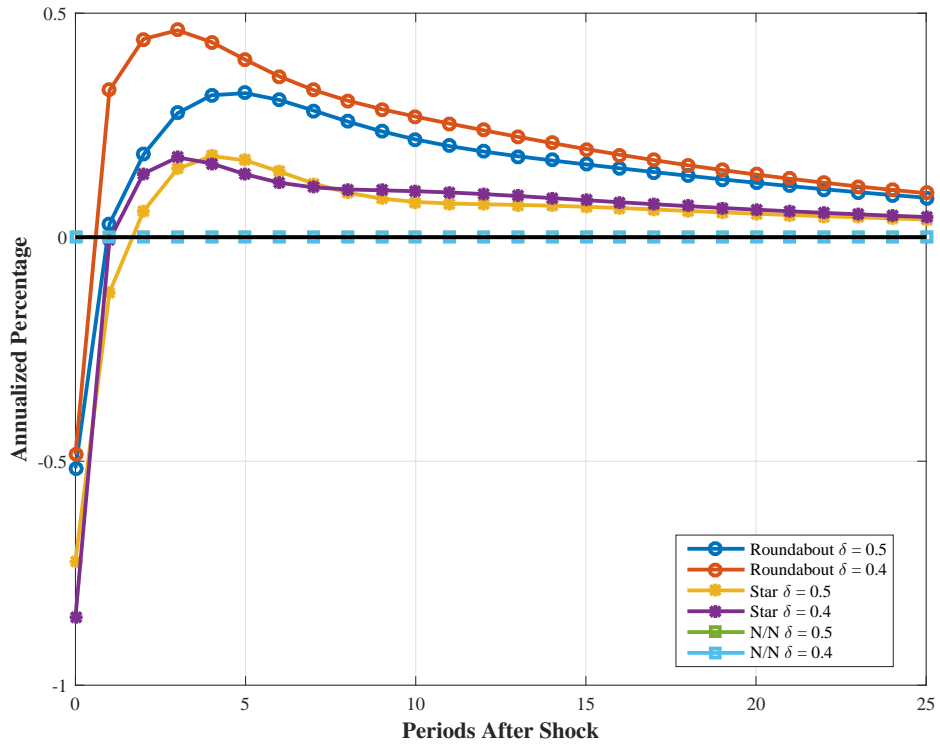


Figure 2.22: IRF to Common Price-Markup Shock. Varying Intermediate Goods Shares.

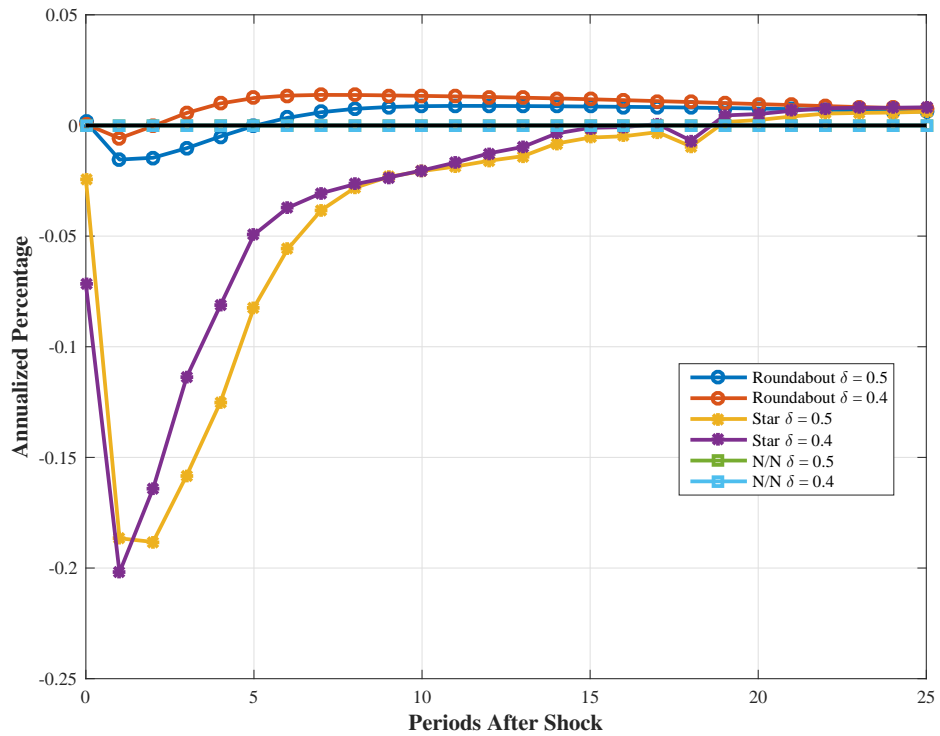


Figure 2.23: IRF to Idiosyncratic Price-Markup Shock. Varying Intermediate Goods Shares.

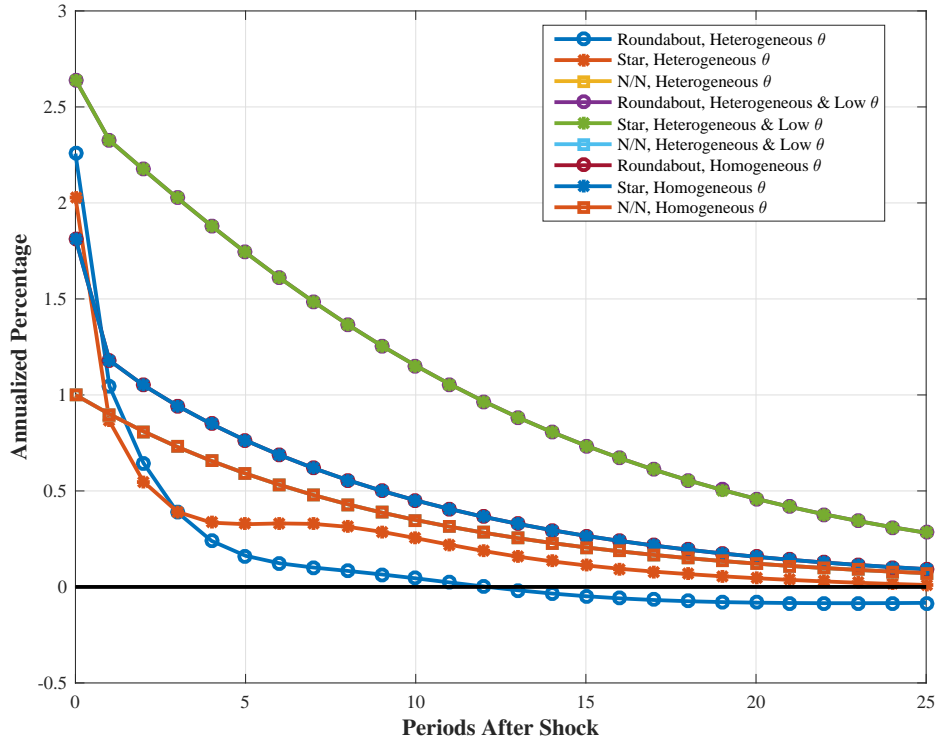


Figure 2.24: IRF to Common Productivity Shock. Varying Degrees of Price Stickiness.

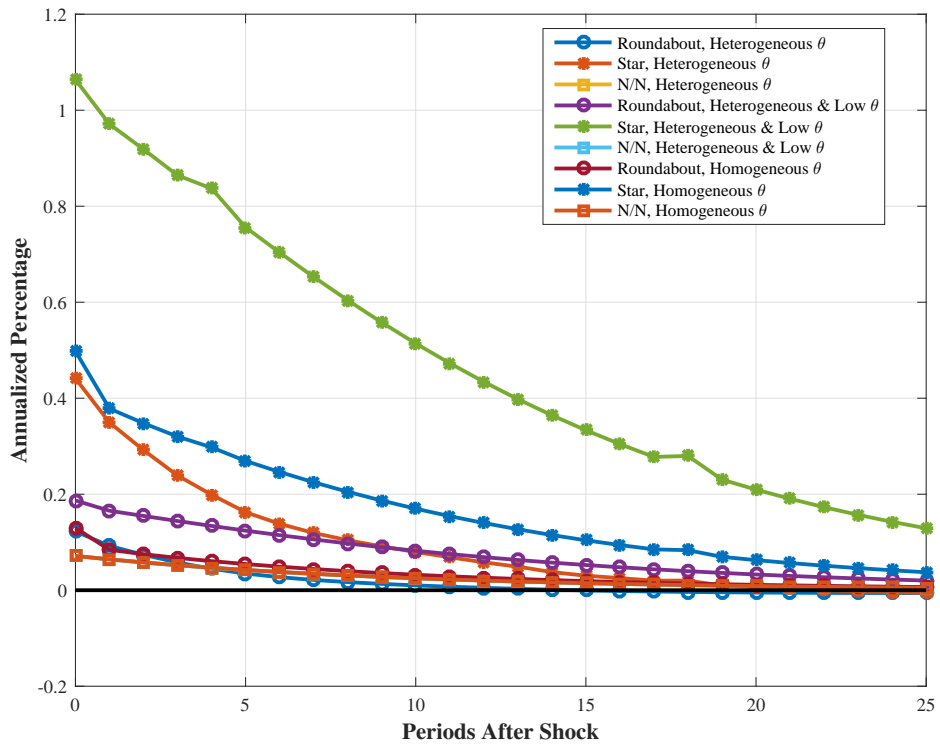


Figure 2.25: IRF to Idiosyncratic Productivity Shock. Varying Degrees of Price Stickiness.

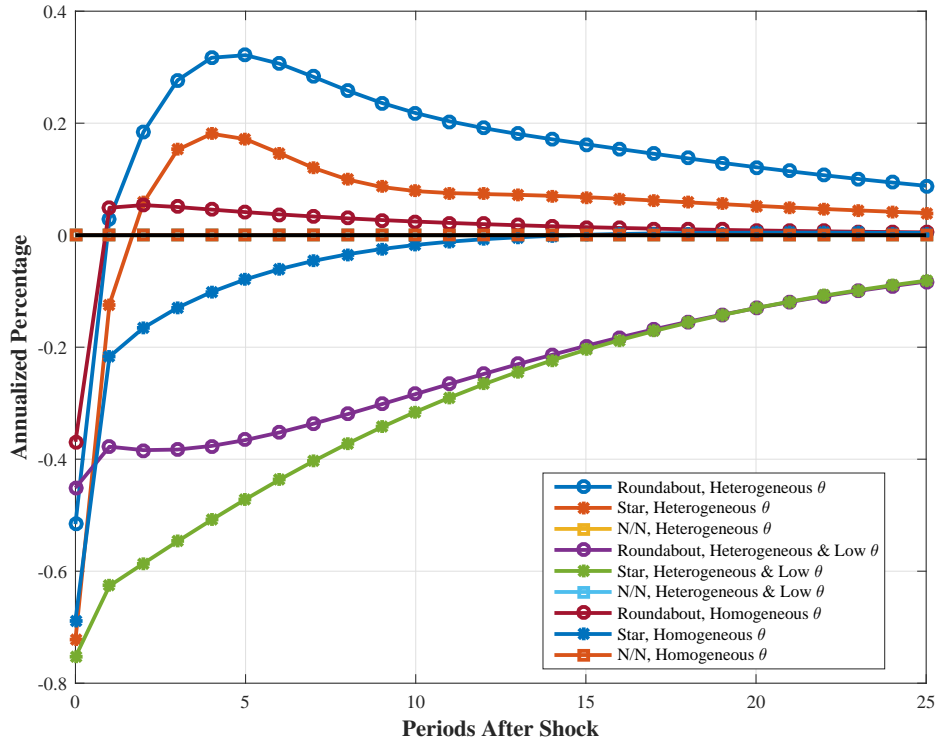


Figure 2.26: IRF to Common Price-Markup Shock. Varying Degrees of Price Stickiness.

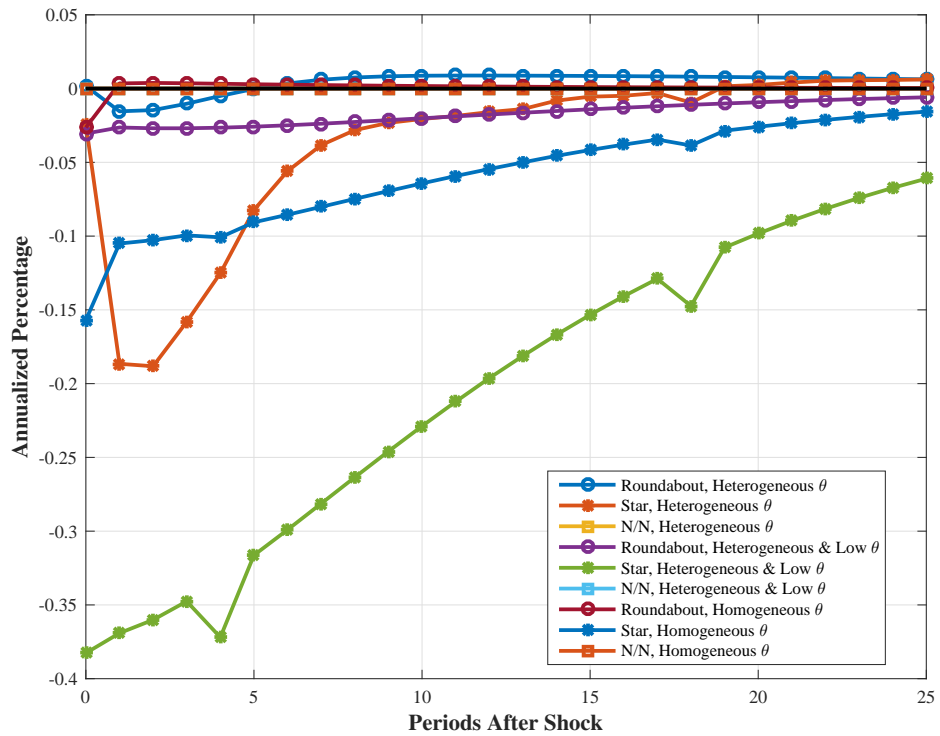


Figure 2.27: IRF to Idiosyncratic Price-Markup Shock. Varying Degrees of Price Stickiness.

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