

How do supply shocks to inflation generalize? Evidence from the pandemic era in Europe*

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Abstract

We document how the interaction of supply chain pressures, elevated household inflation expectations, and firm pricing power contributed to the pandemic-era surge in consumer price inflation in the euro area. Initially, supply chain disruptions raised inflation, particularly in manufacturing sectors through a cost-push channel, while also elevating inflation expectations. In turn, higher inflation expectations appear to have lowered the price elasticity of consumer demand and strengthened firms' pricing power, enabling even firms in service sectors, that were initially unaffected by supply constraints, to raise markups. Through this expectations mechanism, localized inflation in sectors sensitive to supply-side shocks generalized into broad-based inflation.

JEL: E31, E58, D84, L11.

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1 Introduction

In response to the outbreak of the COVID-19 pandemic in March 2020, governments and central banks implemented substantial stimulus measures to avert a deep recession. The global economy and aggregate demand rebounded rapidly, leading to a rise in inflation (see [Reis, 2022a](#)). Throughout 2021 and 2022, additional supply-side shocks intensified inflationary pressures. Notably, new pandemic waves and the resultant restrictions on economic activity put severe strain on global value chains, resulting in shortages across various sectors. Moreover, energy prices began to climb in 2021 and surged dramatically in early 2022, following the Russian invasion of Ukraine, causing inflation rates to reach their highest levels in four decades in many countries across the globe, and in particular in the euro area. Initially, these supply-side shocks exerted more inflationary pressure on directly affected sectors such as manufacturing (see [Figure 1](#)). However, despite a later easing of these shocks, inflation became increasingly generalized across the entire European economy, extending even to sectors not directly impacted by the supply constraints, such as services (again, see [Figure 1](#)).

Using several cross-sectional and time-series tests, we show how supply chain pressures, household inflation expectations, and firm pricing power interacted to fuel the pandemic-era surge, and eventual generalization, of consumer price inflation in the euro area. Our findings are consistent with the sequence of effects illustrated in [Figure 2](#).

First, we document localized cost pass-through effects from supply chain constraints, which started rising in late 2020/early 2021, on prices—particularly in sectors directly affected by these disruptions (manufacturing), and among firms with pricing power (left panel). Second, we demonstrate that these localized supply constraints also contributed to a rise in household inflation expectations, which started to increase in early 2021 (middle section). Households, observing higher prices in their own consumption baskets through the *experience channel* and receiving news about supply-side shocks—such as cargo ship delays signaling rising costs—via the *news channel*, revised their inflation expectations in anticipation of

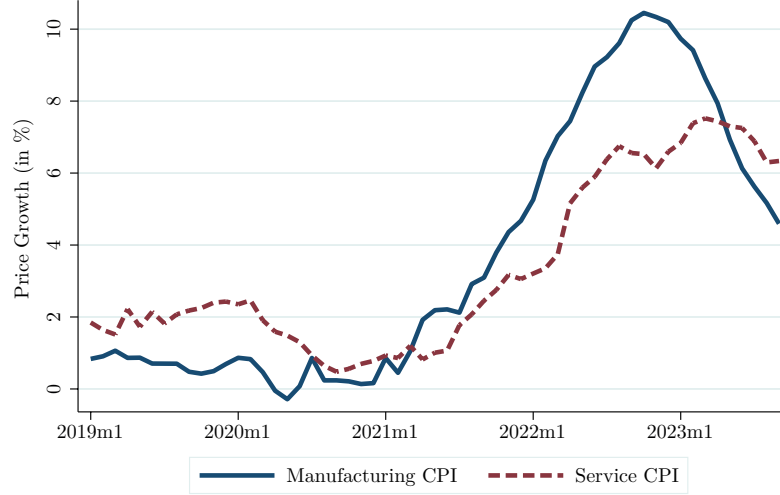


Figure 1: Manufacturing and service consumer price inflation. This figure shows the average CPI growth for manufacturing and service products.

broader increases in costs and prices. Ultimately, these elevated inflation expectations appear to have facilitated a pass-through to broad-based inflation, which began to emerge in the second half of 2021; that is, higher inflation even in sectors not initially affected by supply-side cost shocks (services), and particularly among firms with greater market power (right side). Taken together, our analysis suggests that elevated household inflation expectations act as the key transmission channel through which localized inflationary shocks evolve into broader-based inflation.

A potential explanation for the mechanism is as follows: Following supply-side disruptions, households face a challenging signal extraction problem, needing to determine whether the shock and the resultant cost and price increases are local or widespread, which influences their price search efforts and consumption choices (Benabou and Gertner, 1993; Fishman, 1996; Gaballo and Paciello, 2022). When these shocks are perceived as common and widespread—aligned with elevated inflation expectations—households tend to search less for better deals, leading to higher reservation prices and lower price sensitivity. This behavior allows even unaffected firms to sustain higher markups without substantial sales losses. Our

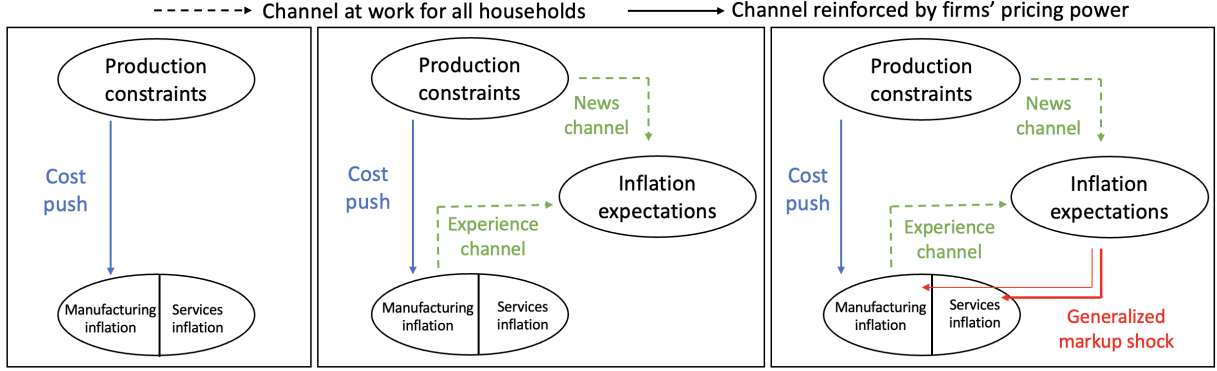


Figure 2: From supply chain constraints and *localized* inflation to high inflation expectations and *generalized* inflation. This figure shows the main channels at the core of our analysis. The left panel shows how production constraints might affect inflation through a cost-push channel. The middle panel shows how production constraints and inflation might increase inflation expectations. The right panel shows how inflation expectations might contribute to the rise in generalized inflation.

results can thus be seen as a tangible manifestation of “excuseflation.”¹

To conduct our tests, we combine several data sets at various units of observations. At the industry-country-time level, we observe (i) firms’ production constraints from the Joint Harmonised EU Programme of Business and Consumer Surveys (BCS), and (ii) energy consumption data from Eurostat. At the country-time and at the household-time level, we observe inflation expectations from the BCS and the European Central Bank (ECB) Consumer Expectations Survey (CES), respectively. At the product-country-time level, we observe Consumer Price Index (CPI) data from Eurostat. Finally, at the firm-time level, we examine pricing strategies extracted from earnings call transcripts obtained from the LSEG Workspace Transcripts & Briefs database along with financial data from Compustat Global, which we use to estimate firm markups.

¹We use this term to capture the idea that sellers may exploit unusual, opaque disruptions that appear broad or systemic in the eyes of consumers to raise prices (Bloomberg, “How ‘Excuseflation’ Is Keeping Prices—and Corporate Profits—High”, March 9, 2023). This idea has also been echoed by both academics and policymakers. For example, Olivier Blanchard stated “*did some price makers actually thought: OK, nobody understands anything, let me increase prices although I have no reason to do it? Yeah, probably. Human nature is human nature [...] But to think that it played a macro-relevant role, I’m still skeptical.*” (Financial Times, June 17, 2024).

Our analysis is structured in five parts. First, we document the pass-through of supply chain constraints to price levels, particularly in manufacturing sectors, consistent with a cost-push channel: product-country pairs facing greater supply constraints exhibit higher CPI growth in the post-pandemic period. An instrumental variable (IV) estimation supports a causal interpretation of this finding. Specifically, we instrument a market’s degree of supply chain disruptions with its firms’ pre-COVID reliance on imports from China paired with Chinese province-time level data on lockdown stringency. We employ granular energy consumption and price data to isolate—and confirm robustness of—the impact of supply chain frictions on inflation from the impact of the contemporaneous surge in energy costs.

Second, we show that supply chain constraints feed into broad-based inflation expectations. Specifically, we find a positive association between the prevalence of supply chain constraints in a country with both (i) the share of households with elevated inflation expectations in that country, and (ii) individual short-term (one-year-ahead) and long-term household inflation (three-year-ahead) expectations. We further substantiate the causal link between supply chain disruptions and rising household inflation expectations by employing again the IV approach that capitalizes on the trade shock induced by China’s lockdowns. The household-time level estimation further shows that households more aware of realized inflation during the initial cost-push phase expect CPI growth to increase more when reported supply chain constraints tighten—and this relationship is particularly pronounced in countries with greater exposure to salient information about supply chain disruptions. These findings support both the experience and the news channel of household expectation formations.

Third, we find evidence consistent with elevated household inflation expectations facilitating a generalization of inflation to firms in service sectors—that is, markets not directly exposed to supply chain constraints. In particular, we document that in countries with elevated household inflation expectations, products with a high contribution from service sectors exhibit higher relative CPI growth in 2022 compared to similar products in coun-

tries with less pronounced inflation expectations. To ensure this effect is not driven by demand factors, we employ several controls: (i) we account for potential pent-up demand by controlling for country-level energy costs and the intensity of lockdown measures during the COVID-19 pandemic; (ii) we include product-country-time fixed effects at the 1-digit COICOP level to absorb the impact of broader demand shocks on product categories; and (iii) we control for demand shifts across different product categories using data on final consumption expenditure of households at the product-country-time level.

Moreover, we show that this generalization of inflation (i) is driven by industry-country pairs where firms possess significant market power, and that it (ii) is present in both countries with a high and low share of employees covered by a collective bargaining agreement. The latter finding suggests that the generalization into broad-based inflation is not driven by firms anticipating a rise in labor costs. Finally, the generalization effect is robust to controlling for potential delays in supply shock transmission along the supply chain, indicating that it is not driven by delayed upstream cost-push spillovers.

We then examine the role of firms’ pricing behavior in the generalization of inflationary pressures and how it is shaped by household inflation expectations, firms’ pricing power, and their interaction. To this end, we combine firm-level financial data and estimated markups following [De Loecker et al. \(2020\)](#) with a systematic analysis of company earnings call transcripts using a Large Language Model (OpenAI’s GPT-4o). In line with our proposed mechanism, we find that executives of firms in countries with elevated household inflation expectations more frequently reference pricing power due to resilient demand—an indicator of a low consumer price sensitivity—compared to executives in countries with lower inflation expectations. Moreover, such references are predictive of higher markups in the subsequent quarter, while mentions of pricing power in combination with scarcity-driven factors that also contribute to increased costs, viz., supply chain disruptions, labor constraints, or energy costs, are less frequent and generally not associated with markup increases.

Next, we examine how this dynamic differs across sectors. In 2022, once supply con-

straints had eased but inflation expectations were nevertheless elevated, service-sector firms citing pricing power associated with resilient demand were able to catch up to manufacturing firms in their price increases. This provides further evidence that pricing power linked to resilient demand played a key role in driving the generalization of inflation across the economy.

Lastly, we analyze how pre-pandemic pricing power shaped firms’ ability to raise markups during the pandemic. Consistent with our findings based on company earnings call transcripts, we find that in countries with elevated household inflation expectations, firms with higher pre-COVID pricing power sustained relatively higher markups in 2022, while such firms in countries with stable inflation expectations experienced sharper declines. These findings suggest that the interaction between inflation expectations and firm-level pricing power can amplify and propagate inflationary pressures throughout the broader economy.

Overall, our results suggest that opaque cost shocks—such as the one caused by supply-side disruptions during the COVID-19 pandemic—can lead households to anticipate a broad-based increase in input costs and prices. This, in turn, can give pricing power even to firms not directly affected by the initial shock, allowing localized inflationary pressures to spread into broad-based inflation. As inflation began to rise in 2021, central banks initially tolerated the elevated inflation levels under the assumption that the supply shocks were transitory in nature. However, our results highlight that if supply-side shocks lead to a de-anchoring of inflation expectations, they can trigger a disproportionate, widespread, and persistent surge in actual inflation—operating through a rise in firms’ pricing power.

Related literature. The literature on supply-side factors and their connection to inflation and inflation expectations covers several interconnected areas of research, including (i) the effect of supply shocks on prices, (ii) the formation of inflation expectations, and (iii) the relationship between inflation and inflation expectations.

A variety of studies has investigated the impact of supply-side frictions on prices and price expectations. In the theoretical literature, [Alessandria et al. \(2022\)](#) and [Kalemli-Ozcan et al.](#)

(2022) model the aggregate effects of supply chain shocks during the COVID-19 pandemic. Bilbiie and Känzig (2023) investigates the interplay of corporate profits and income distribution in shaping inflation and aggregate demand. In the empirical literature, Carriere-Swallow et al. (2022) and Jiménez-Rodríguez and Morales-Zumaquero (2022) examine the effects of global shipping costs and commodity prices, respectively, on domestic prices and inflation expectations. Benigno et al. (2022) and Bai et al. (2024) propose new indices to capture global supply chain pressures and their impact on inflation.²

More closely related to our paper, Franzoni et al. (2023) focuses on the role of market power in the propagation of the initial cost-push shock. The authors provide evidence that supply chain constraints can help explain about 19% of the U.S. inflation in industries with more asymmetric firm size distribution, where supply chain shortages are more likely to benefit large firms at the expense of smaller firms. Similarly, Bräuning et al. (2022) investigates the effect of market concentration on the pass-through of cost shocks into prices in the U.S., suggesting that increased industry concentration may amplify local inflationary pressures. We contribute to this literature by showing that supply-side shocks can *interact* with household inflation expectations and firm pricing power, leading to broad-based inflation.

More generally, our paper is also related to the literature on the formation of inflation expectations and their link to household behavior, firm behavior, and inflation. Weber et al. (2022) reviews the literature on inflation expectations, highlighting systematic upward bias, large disagreements, high forecast uncertainty, deviations from professional forecasters, joint short-long term adjustments (suggesting potential “unanchoring”), inattention in stable economies, and varied expectations across countries. Moreover, there is a large body of work on how inflation expectations affect households’ economic decisions (Crump et al., 2022;

²There is also a growing body of country-specific research on the effects of supply-side factors on inflation (Isaacson and Rubinton, 2022; Amiti et al., 2022; Ball et al., 2022; Anayi et al., 2022; Bernanke and Blanchard, 2023; Comin et al., 2023; Finck and Tillmann, 2022; Celasun et al., 2022; Binici et al., 2022).

Dräger and Nghiem, 2021; D’Acunto et al., 2022; Ichiue and Nishiguchi, 2015; Duca-Radu et al., 2021; Armantier et al., 2015; Malmendier and Nagel, 2016; Coibion et al., 2023). Our paper adds to this literature by providing evidence that elevated household inflation expectations are a key transmission channel through which inflation generalizes in response to localized inflationary cost shocks.

2 Data and stylized facts

In this section, we outline our data sources (Section 2.1) and highlight key stylized facts that characterize the post-pandemic inflationary environment in the euro area (Section 2.2).

2.1 Data sources

Our analysis is based on several data sets for the euro area from 2019:Q1 to 2022:Q4. We use data about (i) firms’ production constraints; (ii) household inflation expectations; (iii) CPI growth, (iv) firm financials; and, (v) corporate earnings call transcripts. In Appendix OA.1, we provide a detailed explanation of our data sources and explain how we process and transform the data. Below, we summarize the key datasets used.

Joint Harmonised EU Programme of Business and Consumer Surveys (BCS).

We obtain information about firms’ production constraints at the industry-country-time level and household inflation expectations at the country-time level from the BCS conducted by the European Commission’s Directorate-General for Economic and Financial Affairs (DG ECFIN). These surveys are conducted on a monthly and quarterly basis, covering 37,990 corporations across the manufacturing, services, retail trade, and construction industries, as well as 31,810 households from the 27 EU member countries.

The use of survey data to gauge constraints to firms’ production stemming from supply chain disturbances offers two key advantages: (i) Survey data offers more immediate and direct evidence regarding firms’ production constraints compared with raw supply chain

data, which may not fully capture their extent due to firms’ ability to adapt, either through sourcing alternative material inputs or adjusting their supply chains; (ii) Survey data about constraints to production can serve as a leading indicator for increases in supply-side costs since firms often anticipate the impact of supply shocks, such as container ship congestion, before they translate into a tangible material shortage.

ECB Consumer Expectations Survey (CES). Furthermore, we use newly available anonymized household-time level inflation expectations microdata from the CES launched in 2020. Its sample covers six key euro area countries: Belgium, France, Germany, Italy, Spain, and the Netherlands, and it is representative of the euro area population (Bańkowska et al., 2021). A total of 18,492 distinct respondents participated in the 12 CES waves and households appear repeatedly in the survey, allowing us to compare responses of the same household over time.

Other data sources. We obtain monthly data on consumer prices at the product-country-time level, data about industry-country-time level energy input use, and energy prices at the country-time level from Eurostat. For our Large Language Model (LLM) analysis, we use OpenAI’s GPT-4o model to analyze earnings call transcripts from the LSEG Workspace Transcripts & Briefs database (see Section 5.2 for more details). Finally, we use firm-time level financial data from Compustat Global to estimate firm markups following De Loecker et al. (2020).

2.2 Stylized facts: From localized to generalized inflation

The COVID-19 pandemic triggered a contemporaneous surge in supply chain disruptions, inflation, and inflation expectations across the euro area.

The top panel in Figure 3 shows that firms began reporting significant shortages of material inputs in 2021:Q1, followed by less pronounced labor shortages from 2021:Q2 onward. Both production constraints began easing by 2022:Q1 and 2022:Q3, respectively. Supply

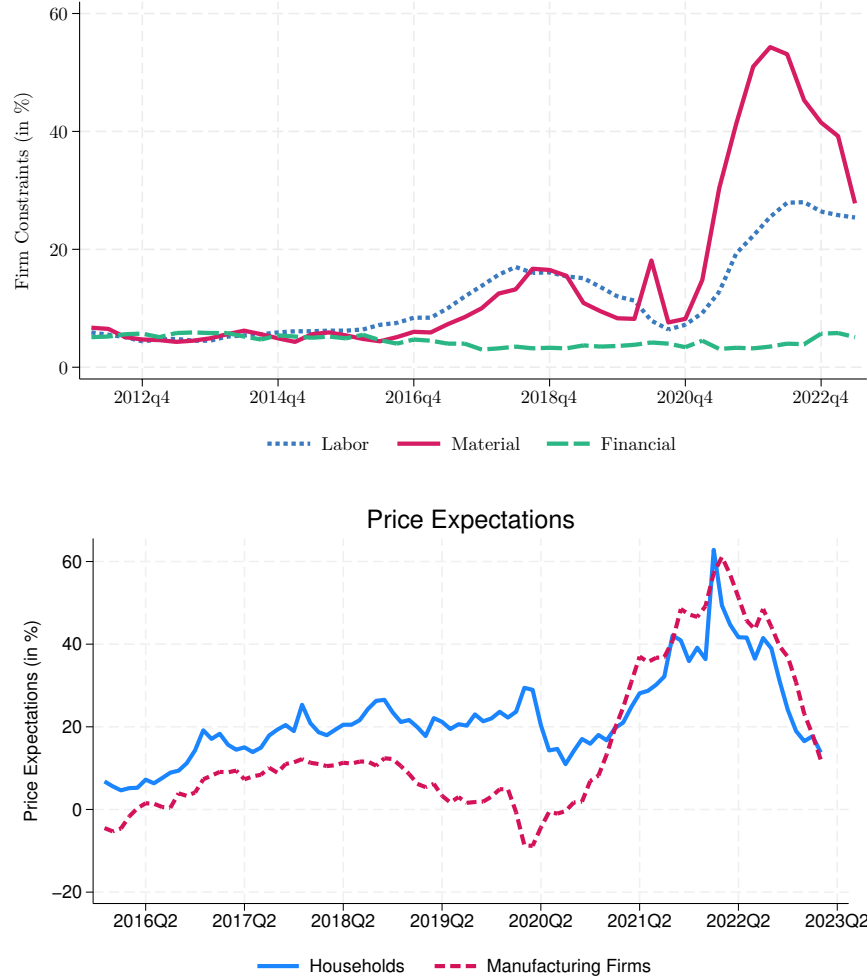


Figure 3: Production constraints and rising inflation expectations. The top panel shows the share of firms answering the following survey question: “*What main factors are currently limiting your production?*” as follows: (i) shortage of labor, (ii) shortage of material/equipment, (iii) financial constraints. The data runs at a monthly frequency from January 2016 to April 2023 and is obtained from the BCS firm survey for 27 EU countries, where the unit of observation is industry-country. The bottom panel shows the evolution of households’ and manufacturing firms’ inflation expectations over time. These expectations are measured as the share of households/firms expecting prices to increase more rapidly minus share of households/firms expecting inflation to fall over 12 months (for households) and 3 months (for manufacturing firms). The data source is the monthly survey on euro area households’ and firms’ inflation expectations.

chain shocks often prompt producers to raise prices to protect profit margins in response to challenges in sourcing materials and elevated input costs. Consistent with this mechanism, the CPI began to rise in 2021:Q1, peaking in October 2022 (see [Figure OA.1](#)). Although price increases may propagate through firm-to-firm linkages, the initial *cost-push* inflationary impulse remained primarily confined to products in sectors directly affected by the supply-side shock, such as manufacturing.

Then, starting in the second half of 2021, localized inflation in supply-sensitive sectors gave way to a more widespread inflationary environment, with even sectors not directly affected by supply chain disruptions, such as services, experiencing high inflation rates (see top panel of [Figure 4](#)). While by late 2021, CPI year-over-year growth was 5%, with 27% of products experiencing inflation above 4% and 50% below 2%, by the end of 2022, CPI had risen to 9%, with 70% of products exceeding 4% inflation.

The bottom panel of [Figure 4](#) confirms this transition to generalized inflation, displaying the survey-based measure of supply chain constraints alongside an “inflation diffusion” index, which assigns values of 0, 50, and 100 to product-quarters with annual inflation below 2%, between 2% and 4%, and above 4%, respectively. Despite easing supply chain bottlenecks in 2022, the index continued to rise as inflation became more broad-based.

This generalization can plausibly be explained by an interplay between supply-side disruptions, household inflation expectations and purchasing behavior, and firm pricing power. While their immediate cost-push effect is localized, supply-side constraints can increase inflation expectations when households experience higher prices and observe news coverage about the supply shocks (e.g., [D’Acunto et al., 2021](#); [Larsen et al., 2021](#)). As supply chain disruptions intensified, both households and firms began to expect higher inflation (see the bottom panel of [Figure 3](#)).³ However, households face a difficult signal extraction problem

³These expectations are measured as the share of households or firms expecting prices to increase more

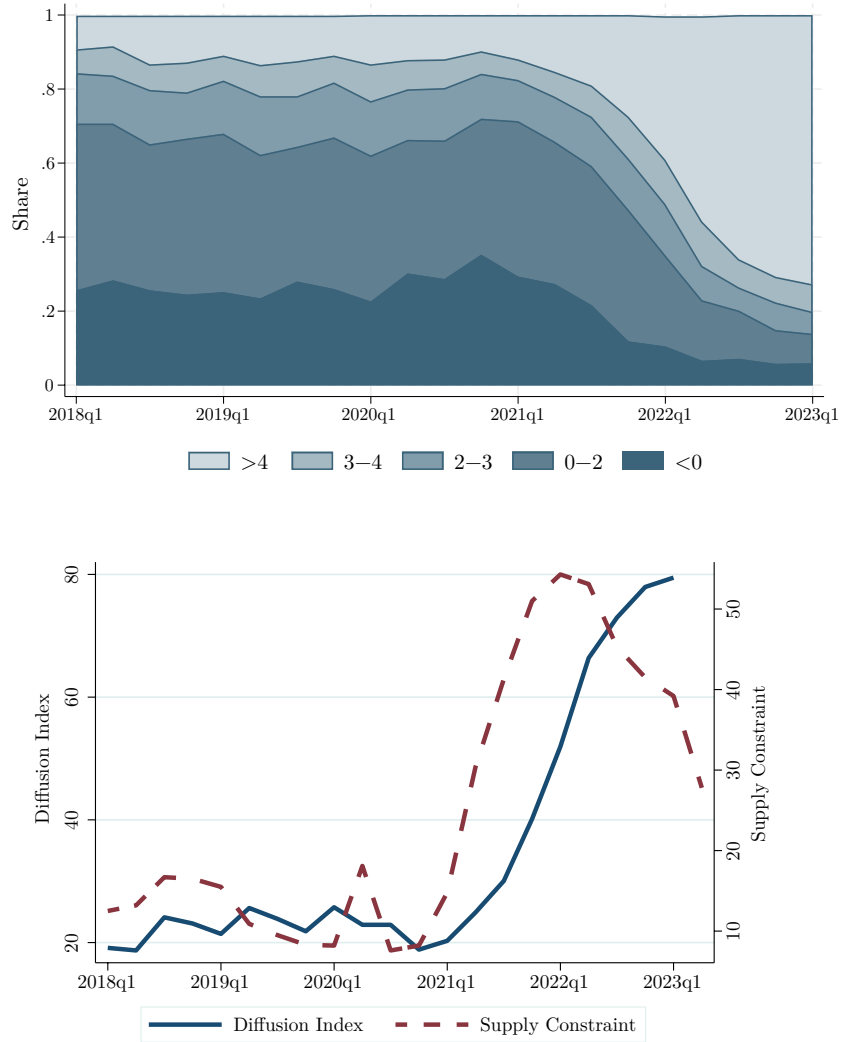


Figure 4: Localized inflation in 2021 becomes broad-based in 2022. The top panel provides a visual representation of inflation trends at the product-country-time level in the euro area. Each shaded area shows the share of product-country pairs that, in each quarter, have a specific CPI year-over-year growth as outline in the legend. The bottom panel of this figure shows the time-series evolution of an inflation diffusion index (blue line) and the time-series evolution of the supply chain constraint (red dashed line). The diffusion index is defined by assigning a value of 0 to product-quarters that have an annual inflation of less than 2%, a value of 50 to product-quarters with an annual inflation between 2% and 4%, and a value of 100 to product-quarters with an annual inflation of more than 4%.

in response to supply shocks: they must assess whether the disruptions affect only specific producers or are common across many suppliers, in order to make optimal decisions about how much effort to invest in understanding price distributions across firms and products, which in turn shapes their consumption choices.

Search theory (Benabou and Gertner, 1993; Fishman, 1996; Gaballo and Paciello, 2022) suggests that consumers perceiving a supply-side shock as widespread (i.e., a common shock affecting many suppliers), a perception aligned with generalized inflation expectations (Dietrich, 2024), reduce their effort to seek better deals elsewhere when confronted with high prices. This translates into higher reservation (acceptance) prices and a lower price elasticity of demand; that is, households become less “choosy” and tend to enter into less adequate transactions. Consequently, *all* firms, even those not directly affected by the initial supply chain disruptions, can “hide” behind aggregate cost and inflationary noise to maintain, or even raise, their markups without risking a considerable decline in sales.

Our empirical analysis provides evidence supporting this transition from localized to generalized broad-based inflation via household expectations and firms’ pricing power.

3 Pass-through of supply chain constraints

We start by presenting evidence consistent with a post-COVID pass-through of supply chain disruptions to price levels through a cost-push channel (Section 3.1) and to household inflation expectations (Section 3.2).

rapidly minus the share of households or firms expecting inflation to fall over the next 12 months for households and 3 months for firms (see Weber et al., 2022; D’Acunto and Weber, 2024).

3.1 Pass-through to localized inflation

We document the initial *localized* cost-push inflationary impulse, leveraging cross-sectional variation in supply chain disruptions at the product-country level. We then (i) document how this correlation varies during 2020–22, (ii) show that supply chain constraints propagate locally through firm-to-firm linkages, and (iii) present an IV estimation approach based on firms’ reliance on imports from China paired with Chinese province-level data on lockdowns.

Baseline analysis. We test the effect of increasing supply chain pressures (as perceived by firms) on CPI growth by estimating the following specification at the product-country-quarter level:

$$CPI\ Growth_{pct+1} = \beta_1 Material_{pct} + \beta_2 Material_{pct} \times Covid_t + \nu_{ct} + \mu_{pc} + \epsilon_{pct}, \quad (1)$$

where p is a product, c is a country, and t is a quarter. $Material_{pct}$ measures the share of firms producing product p for the market in country c indicating that their production is constrained by supply chain bottlenecks. The sample period spans 2019:Q1 to 2022:Q4 at a quarterly frequency. We use 2019 as our “base year.” The $Covid_t$ dummy is equal to one for the period after the start of the COVID-19 pandemic (i.e., after and including 2020:Q2) and zero otherwise. We measure the CPI growth in quarter t as the yearly CPI growth from quarter $t - 3$ to quarter $t + 1$. This approach allows us to gauge the effect of our independent variable of interest ($Material_{pct}$) in quarter t on the one-quarter ahead dependent variable of interest ($CPI\ Growth_{pct+1}$), while accounting for seasonality by taking the same quarter in the previous year as base year for the growth calculation.

By including country-quarter and product-country fixed effects, we isolate the effect of firms’ perceived supply constraints holding constant the time-varying demand at the country level. Specifically, the country-quarter fixed effects absorb all shocks at the national level that might affect price levels (e.g., country-level demand shocks, energy shocks, government support packages, changes in tax legislation and national regulations). The product-country

fixed effects control for time-invariant product-country characteristics.

Our analysis includes firms in both manufacturing and services. For manufacturing firms, we observe supply chain constraints ($Material_{pct}$), alongside other supply factors ($Labor_{pct}$, $Financial_{pct}$, and $Other_{pct}$). These variables represent the share of firms that report being constrained by each respective factor. For services, we observe shortages in equipment and space ($Equipment_{pct}$), in addition to the constraints $Labor_{pct}$, $Financial_{pct}$, and $Other_{pct}$. We conservatively measure supply chain constraints solely using the $Material_{pct}$ variable, setting this variable to zero for service firms.⁴

The first column of Table 1 shows that reported supply chain constraints are positively associated with CPI growth in the post-pandemic period (after 2020:Q2) relative to 2019. Specifically, a one standard deviation higher supply chain constraint is associated with a 1.3pp higher annual CPI growth in the COVID-19 pandemic period, which suggests a meaningful pass-through of supply-side frictions to consumer prices.

In Column (2), we further control for the contemporaneous energy cost shock by including the interaction term $Energy\ Use_{pc} \times Energy\ Inflation_{ct}$, which allows us to disentangle the effect of supply chain frictions on inflation from the impact of rising energy costs. $Energy\ Inflation_{ct}$ is the time-varying country-level CPI index for energy, capturing the evolution of a country’s overall energy costs over time. $Energy\ Use_{pc}$ is an industry-country pair’s energy input before the COVID-19 pandemic, measured in 2019 and scaled by the country’s total energy use.⁵ The year 2019 provides a pre-COVID baseline for energy usage, reflecting “normal” economic conditions without pandemic-related distortions. Column (2) shows that accounting for energy costs does not significantly alter the coefficient capturing the impact of supply chain frictions, suggesting that, in terms of pass-through to CPI growth, the shocks

⁴This approach attenuates the estimated magnitude of an eventual supply chain constraint pass-through in the full sample.

⁵Our results are robust to employing the nonscaled energy input level.

Dependent variable: CPI Growth _{pct+1}	(1)	(2)	(3)	(4)	(5)	(6)
Material _{pct} × Covid _t	0.083*** (0.024)	0.081*** (0.023)				
Material _{pct} × 2020 _t			0.122*** (0.036)	0.124*** (0.038)	0.121*** (0.038)	0.080** (0.039)
Material _{pct} × 2021 _t			0.071** (0.028)	0.070** (0.028)	0.067** (0.026)	0.053** (0.025)
Material _{pct} × 2022 _t			0.069** (0.027)	0.064** (0.026)	0.062** (0.025)	0.052** (0.024)
Energy Use _{pc} × Energy Inflation _{ct}		1.304** (0.485)		1.314** (0.485)	1.318** (0.486)	1.380** (0.489)
Observations	8,515	8,515	8,515	8,515	8,515	8,515
R-squared	0.506	0.513	0.506	0.513	0.513	0.517
Other constraints					✓	✓
Other constraints interacted						✓
Country-time FE	✓	✓	✓	✓	✓	✓
Product-country FE	✓	✓	✓	✓	✓	✓

Table 1: Supply chain constraint pass-through to CPI. This table presents estimation results from Specification (1) in Column (1)–(2). Columns (3)–(6) present estimation results based on the same specification with yearly time dummies. The subscript notation is defined as follows: p is a product, c is a country, and t is a quarter. The dependent variable is the one-quarter ahead annual CPI growth at the product-country-time level. *Covid* is a dummy equal to one for the period after the start of the COVID-19 pandemic (i.e., after and including 2020:Q2) and zero otherwise. *Material*, *Labor*, *Financial*, *Equipment*, and *Other* measure the share of firms that indicate that their production is constrained by the respective constraint. All constraints are transformed from the industry-country-time level to the product-country-time level using an input-output table and the share of consumption that each industry contributes to the final household consumption of a particular product. Non-reported controls include the other perceived constraints to production (*Labor*, *Financial*, *Equipment*, and *Other*) uninteracted in Columns (5)–(6) and, in addition, these other constraints interacted with the three year dummies in Column (6). *Energy Inflation* is the country-time level CPI index for energy. *Energy Use* is a product-country pair’s energy input before the COVID-19 pandemic, measured in 2019 and scaled by the country’s total energy use. We exclude the product “Energy” from the regression. Standard errors are double-clustered at the country-product and quarterly level and are reported in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

from supply chain disruptions are largely orthogonal to those from energy costs.

Time variation of pass-through. Having established a correlation between supply chain disruptions and consumer prices for the COVID-19 pandemic period, we now examine its potential time variation throughout this period. To this end, we split the *Covid_t* dummy in three yearly dummies equal to one in 2020, 2021, and 2022, respectively—where the year dummy for 2020 equals one for Q2–Q4 only (i.e., only after the COVID-19 outbreak).

Columns (3)–(6) of Table 1 indicate that the link between supply chain constraints and CPI growth exists for all years. These columns estimate progressively more stringent spec-

ifications. Column (3) only includes the supply chain constraint. In Column (4), we again additionally control for energy cost shocks. Column (5) further incorporates other production constraints ($Labor_{pct}$, $Financial_{pct}$, $Equipment_{pct}$, and $Other_{pct}$), which are omitted from the table for brevity. Finally, Column (6) interacts each of these constraint variables with three year dummies (also omitted for brevity). The estimated coefficients for the supply chain constraint remain stable across all specifications. Note that, while the coefficient estimate for 2020 is the largest, CPI growth had not yet risen significantly in that year as supply chain constraints had not yet fully materialized.

Localized cost-push pass-through along the supply chain. Next, we confirm that supply chain disruptions contribute to localized inflation by focusing on bottlenecks among *upstream suppliers*. Using the Figaro input-output table from Eurostat, we quantify the share of firms reporting production constraints due to specific supply factors ($Material_{pct}$, $Labor_{pct}$, $Financial_{pct}$, $Equipment$, or $Other_{pct}$) in quarter t among suppliers providing input goods to firms that produce final consumption goods p in country c in year t :

$$Material\ Supply_{pct} = \sum_{\bar{j}, \bar{c}} \left[COICOP\ Share_{pc\bar{j}} \times Consumption\ Share_{c\bar{j}\bar{c}} \times \left(\sum_{\underline{j}, \underline{c}} Supply\ Share_{\bar{j}\bar{c}\underline{j}\underline{c}} \times Constraint_{\underline{j}\underline{c}t} \right) \right] \quad (2)$$

The variable $Supply\ Share_{\bar{j}\bar{c}\underline{j}\underline{c}}$ represents the contribution of supplier industry \underline{j} in country \underline{c} to customer industry \bar{j} in country \bar{c} . $Constraint_{\underline{j}\underline{c}t}$ captures the share of firms in industry \underline{j} in \underline{c} reporting that their production is restricted by a specific supply factor. The variable $COICOP\ Share_{pc\bar{j}}$ captures the relative weights of industry \bar{j} 's (CPA classification) contribution to the production of product p (COICOP classification) in country c , while $Consumption\ Share_{c\bar{j}\bar{c}}$ captures the contribution of industry \bar{j} in country \bar{c} to final household consumption in country c .

As expected, products that are manufacturing-intensive experience significantly greater exposure to upstream supply chain disruptions compared to service-intensive products. Specifically, manufacturing products exhibit a $Material\ Supply_{pct}$ of 5.59, roughly three times larger

Dependent variable: $\text{CPI Growth}_{pct+1}$	(1)	(2)	(3)	(4)	(5)	(6)
$\text{Material Supply}_{pct} \times \text{Covid}_t$	0.270*** (0.072)	0.263*** (0.069)				
$\text{Material Supply}_{pct} \times 2020_t$			0.258*** (0.073)	0.261*** (0.076)	0.260*** (0.073)	0.216** (0.074)
$\text{Material Supply}_{pct} \times 2021_t$			0.280*** (0.081)	0.271*** (0.079)	0.271*** (0.079)	0.294*** (0.076)
$\text{Material Supply}_{pct} \times 2022_t$			0.274*** (0.082)	0.255*** (0.079)	0.256*** (0.079)	0.286*** (0.080)
$\text{Financial Supply}_{pct} \times 2020_t$						-0.047 (0.054)
$\text{Financial Supply}_{pct} \times 2021_t$						-0.012 (0.075)
$\text{Financial Supply}_{pct} \times 2022_t$						-0.055 (0.091)
$\text{Labor Supply}_{pct} \times 2020_t$						0.104 (0.062)
$\text{Labor Supply}_{pct} \times 2021_t$						-0.094* (0.047)
$\text{Labor Supply}_{pct} \times 2022_t$						-0.137** (0.058)
$\text{Other Supply}_{pct} \times 2020_t$						-0.009 (0.034)
$\text{Other Supply}_{pct} \times 2021_t$						-0.010 (0.041)
$\text{Other Supply}_{pct} \times 2022_t$						0.000 (0.000)
$\text{Energy Use}_{pc} \times \text{Energy CPI}_{ct}$		1.275** (0.487)		1.281** (0.484)	1.281** (0.481)	1.300** (0.483)
Observations	8,515	8,515	8,515	8,515	8,515	8,515
R-squared	0.506	0.513	0.506	0.513	0.513	0.514
Other constraints					✓	✓
Other constraints interacted						✓
Country-time FE	✓	✓	✓	✓	✓	✓
Product-country FE	✓	✓	✓	✓	✓	✓

Table 2: Supply chain constraint pass-through to CPI. This table presents estimation results from Specification (1) in Column (1)–(2) and the same specification with yearly time dummies in Columns (3)–(6). The subscript notation is defined as follows: p is a product, c is a country, and t is a quarter. The dependent variable is the one-quarter ahead annual CPI growth at the product-country-time level. *Covid* is a dummy equal to one for the period after the start of the COVID-19 pandemic (i.e., after and including 2020:Q2) and zero otherwise. *Material Supply*, *Labor Supply*, *Financial Supply*, and *Other Supply* measure the share of firms that indicate that their production is constrained by the respective input constraint in year t among the suppliers that provide input goods to firms that sell product p in country c in year t . All constraints are transformed from the industry-country-time level to the product-country-time level using an input-output table and the share of consumption that each industry contributes to the final household consumption of a particular product. Non-reported controls include the other perceived constraints to production (*Labor Supply*, *Financial Supply*, *Equipment Supply*, and *Other Supply*) uninteracted in Column (5) and, in addition, these other constraints interacted with the three year dummies in Column (6). *Energy Inflation* is the country-time level CPI index for energy. *Energy Use* is a product-country pair’s energy input before the COVID-19 pandemic, measured in 2019 and scaled by the country’s total energy use. We exclude the product “Energy” from the regression. Standard errors are double-clustered at the country-product and quarterly level and are reported in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

than the 1.87 average observed for service products.

We then estimate Specification (1), but this time substituting the immediate production constraints of industries that produce and sell goods for final household consumption with the weighted constraints reported by their upstream suppliers (*Material Supply_{pct}*). Table 2 (the columns follow the same structure of Table 1) provides robust evidence that frictions reported by upstream suppliers propagate through the supply chain, ultimately leading to localized inflation. Column (6) shows that only material frictions (not the other constraints) travel downstream, highlighting the unique connection between material constraints, the supply chain dynamics of firms, and their contribution to localized inflation.

IV estimation. Next, we conduct an IV regression approach. This analysis serves two purposes: first, to further validate our survey data; and second, to pinpoint exogenous variations in supply chain frictions. Most importantly, it ensures that the reported material constraints are truly a result of supply chain disruptions, rather than capturing rising consumer demand paired with a lack of scalability in material inputs.

We instrument a market’s degree of supply chain disruptions with its pre-pandemic reliance on imports from China and their resulting susceptibility to the disruptions caused by COVID-19 lockdowns in China:

$$\tilde{B}_{pct} = \text{China Dependence}_{pc,2019} \times \text{Lockdown Stringency}_t,$$

where *China Dependence_{pc,2019}* is the share of material inputs that the respective firms imported from China in 2019 to produce and sell product *p* in country *c* (using data from Eurostat Figaro), while *Lockdown Stringency_t* measures the severity of lockdown measures implemented in the top-5 exporting provinces of China (Guangdong, Jiangsu, Shandong, Shanghai, and Zhejiang) using data from the Oxford COVID-19 Government Response

Dependent variable	(1) First stage: Material_{pct}	(2) Second stage: $\text{CPI Growth}_{pct+1}$
$\text{China Dependence}_{pc,2019} \times \text{Lockdown Stringency}_t$	7.034*** (0.368)	
$\widehat{\text{Material}}_{pct}$		0.079*** (0.017)
F-Test	364.58	
Observations	8,515	8,515
R-squared	0.784	
Controls	✓	✓
Product-country FE	✓	✓
Country-time FE	✓	✓

Table 3: Supply chain constraint pass-through to CPI: IV estimation. This table presents the estimation results from the IV specification. The subscript notation is defined as follows: p is a product, c is a country, and t is a quarter. The first stage results are shown in Column (1), the second stage results in Column (2). The dependent variable in Column (2) is the one-quarter ahead annual CPI growth at the product-country-time level. *Material*, *Labor*, *Financial*, *Equipment*, and *Other* measure the share of firms that indicate that their production is constrained by the respective constraint. All constraints are transformed from the industry-country-time level to the product-country-time level using input-output tables and the share of consumption that each industry contributes to the final household consumption of a particular product. *China Dependence* represents the share of inputs to produce product p in country c that are imported from China in 2019. *Lockdown Stringency* measures the severity of lockdown measures implemented in China’s top-5 exporting provinces. Non-reported controls include the other perceived constraints to production (*Labor*, *Financial*, *Equipment*, and *Other*) and, in addition, the interaction of *Energy Inflation* and *Energy Use*. *Energy Inflation* is the country-time level CPI index for energy. *Energy Use* is a product-country pair’s energy input before the COVID-19 pandemic, measured in 2019 and scaled by the country’s total energy use. We exclude the product “Energy” from the regression. Standard errors are double-clustered at the country-product and quarterly level. We report standard errors in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

Tracker project (OxCGRT).⁶ Our instrument thus gets all of the cross-sectional variation in the exposure of a product’s supply chain to material imports sourced from China, and all of its time-series variation from the lockdown-induced disruptions.

⁶OxCGRT provides the COVID-19 Stringency Index, a composite measure based on nine response indicators including school closures, workplace closures, and travel bans, rescaled to a value from 0 to 100 (100 = strictest). We focus on lockdowns in the five leading Chinese provinces in export contributions to more precisely capture supply chain disruptions. Note that export volumes do not significantly correlate with the severity of COVID-19-related government policies at the provincial level. For instance, Guangdong, despite being a top exporter, experienced relatively moderate COVID-19 restrictions. Conversely, Xinjiang, with some of the most stringent lockdown measures, ranks low in export volumes. To create the consolidated top-5 export COVID-19 stringency index, we take the average of the province-time level index for the top-5 export provinces, collectively representing 67% of the national export total. See Figure OA.2 for the time-series evolution of this aggregate lockdown stringency index.

Table 3 presents the results for the IV estimation. The first stage is in Column (1) and the second stage is in Column (2). The instrument has a positive and significant effect on the reported material frictions of European firms ($Material_{pct}$), with an F-statistic of 365 and a p-value below 0.01, confirming the *relevance* and the strength of the instrument. In the second-stage estimation, we replace the $Material_{pct}$ frictions with the predicted $\widehat{Material}_{pct}$ frictions from the first stage. The dependent variable is again the one-quarter ahead annual CPI growth at the product-country-time level. The IV estimated coefficients confirm the positive effect of an increase in the reported material frictions on CPI growth, suggesting a causal impact of supply chain disruptions on CPI growth.

These results on the pass-through of supply chain constraints on price levels are consistent with the evidence from research examining the recent supply-side disruptions in Europe (Finck and Tillmann, 2022; Binici et al., 2022; Celasun et al., 2022).

3.2 Pass-through to higher inflation expectations

Despite their localized impact on costs and prices, supply-side constraints can generalize into broad-based inflation expectations.⁷ This transmission works through two channels: the *experience* channel and the *news* channel. The experience channel operates through the observable effect of supply-side shocks on prices. Agents experiencing price increases tend to revise their inflation expectations, anticipating similar price movements in the future (Cavallo et al., 2017; D’Acunto et al., 2021). The news channel influences inflation expectations through information about economic developments that are perceived to have an impact

⁷Figure OA.3 shows three snapshots of the distribution of one-year-ahead households’ inflation expectations. Inflation expectations by households and firms shift to the right and become more fat-tailed in 2021 and especially 2022—mirroring past episodes where inflation expectations became unanchored (Reis, 2022b). Using a representative sample of the U.S. population, Andre et al. (2024) demonstrates that even in the U.S.—a country less exposed to supply-side shocks than Europe—households overwhelmingly identified supply-side factors as key drivers of the inflation surge in late 2021 and 2022.

on prices (Carroll, 2003; Dräger and Lamla, 2017; Larsen et al., 2021; Mazumder, 2021; Andre et al., 2024). For example, following reports about shipping container backlogs at Chinese ports, consumers may anticipate rising production costs and adjust their inflation expectations even before any observable price changes. The most recent evidence on this pass-through shows that U.S. consumers expect tariff policies to significantly affect the prices of both imported and domestically produced goods (Coibion et al., 2025).

To provide evidence of a pass-through of supply chain constraints to household inflation expectations, we run three sets of empirical tests: (i) An analysis at the country-quarter level using BCS consumer survey data; (ii) An analysis at the household-quarter level using data from the ECB’s CES; and, (iii) Expanding on the second, an analysis adding measures of households’ awareness of past inflation and their exposure to salient information about supply chain disruptions.

Country-quarter level analysis. In the first set of tests, we examine the pass-through of supply chain constraints to household inflation expectations at the *country-quarter level* using the following specification:

$$\begin{aligned} \hat{\pi}_{ct}^e = & \beta_1 Material_{ct} + \beta_2 Material_{ct} \times Covid_t + \beta_3 Food\ Inflation_{ct} + \beta_4 Energy\ Inflation_{ct} \\ & + \beta_5 Core\ Inflation_{ct} + \beta_6 High\ Perception_{ct} + Other\ Constraints_{ct} + \nu_c + \epsilon_{ct}. \end{aligned} \quad (3)$$

The dependent variable is the share of households in country c that believe consumer prices will increase more rapidly. We control for realized inflation, and alternatively directly for households’ perceptions of past inflation (*High Perception*_{ct}), since the literature has identified households’ beliefs about the inflation over the recent past as strong predictor of their inflation forecast (Ranyard et al., 2008). Furthermore, we decompose realized inflation into core, energy, and food inflation, given that the latter two have been highlighted as strong drivers of household inflation expectations (Coibion and Gorodnichenko, 2015; D’Acunto et al., 2021; Cavallo et al., 2017; D’Acunto et al., 2021; Wong, 2015). In our most stringent

Dependent variable: $\hat{\pi}_{ct}^c$	(1)	(2)	(3)	(4)	(5)	(6)	(7)
$\text{Material}_{ct} \times \text{Covid}_t$	1.265*** (0.191)						
$\text{Material}_{ct} \times 2020_t$		2.648*** (0.340)	2.711*** (0.358)	2.800*** (0.343)	2.860*** (0.350)	2.211*** (0.408)	1.924*** (0.596)
$\text{Material}_{ct} \times 2021_t$		0.986*** (0.195)	1.201*** (0.238)	1.177*** (0.259)	1.137*** (0.268)	0.869*** (0.225)	0.486* (0.286)
$\text{Material}_{ct} \times 2022_t$		1.066*** (0.165)	1.144*** (0.174)	1.103*** (0.214)	1.049*** (0.222)	0.872*** (0.181)	0.607** (0.280)
$\text{Food Inflation}_{ct}$			0.360* (0.179)	0.316 (0.208)	0.041 (0.251)	0.029 (0.271)	
$\text{Energy Inflation}_{ct}$				0.042 (0.071)	0.040 (0.070)	0.084 (0.052)	
$\text{Core Inflation}_{ct}$					0.697 (0.407)	0.522 (0.506)	
$\text{High Perception}_{ct}$							0.104* (0.058)
Observations	288	288	288	288	288	288	288
R-squared	0.545	0.588	0.605	0.606	0.610	0.631	0.656
Other constraints						✓	✓
Other constraints interacted							✓
Country FE	✓	✓	✓	✓	✓	✓	✓

Table 4: Supply chain constraint pass-through to household inflation expectations: Country-level evidence. This table presents estimation results from Specification (3) in Column (1) and the same specification with yearly time dummies in Columns (2)–(7). The subscript notation is defined as follows: c is a country and t is a quarter. The dependent variable is the share of households that believe consumer prices will increase more rapidly at the country-time level. *Covid* is a dummy equal to one for the period after the start of the COVID-19 pandemic (i.e., after and including 2020:Q2) and zero otherwise. *Material*, *Labor*, *Financial*, *Equipment*, and *Other* measure the share of firms that indicate that their production is constrained by the respective constraint. All constraints are transformed from the industry-country-time level to the country-time level using the share of consumption that each industry contributes to the final household consumption. Non-reported controls include the other perceived constraints to production (*Labor*, *Financial*, *Equipment*, and *Other*) uninteracted in Column (6) and, in addition, these other constraints interacted with the three year dummies in Column (7). *Food Inflation*, *Energy Inflation*, and *Core Inflation* are the country-time level CPI indices for food, energy, and core, respectively. *High Perception* is the share of households at the country-time level that believe prices have risen a lot over the last 12 months. Standard errors are double-clustered at the country and quarterly level and are reported in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

specification, we additionally include year interactions for all our controls.

Table 4 presents the estimation results, where in the different specifications we incorporate an increasingly rigorous set of controls. The regression results for the specification without controls (Column (1)) suggest a strong effect of supply chain disruptions on household inflation expectations. Even after including controls for the experience channel—namely realized inflation and households’ perception about past realized inflation (the latter being the most precise control for the experience channel)—the correlation between material input constraints and household inflation expectations remains. However, its magnitude declines

	(1)	(2)
Dependent variable	First stage: Material_{ct}	Second stage: $\hat{\pi}_{ct}^e$
$\sum_p \text{China Dependence}_{pc} \times \text{Lockdown Stringency}_t$	2.806*** (0.602)	
$\widehat{\text{Material}}_{ct}$		2.830*** (0.789)
F-Test	14.3	
Observations	288	288
R-squared	0.779	
Controls	✓	✓
Country FE	✓	✓

Table 5: Supply chain constraint pass-through to household inflation expectations: IV estimation. This table presents the estimation results from the IV specification. The subscript notation is defined as follows: p is a product, c is a country, and t is a quarter. The first stage result is shown in Column (1), and the second stage results in Column (2). The dependent variable in Column (2) is the share of households that believe consumer prices will increase more rapidly at the country-time level. *Material*, *Labor*, *Financial*, *Equipment*, and *Other* measure the share of firms that indicate that their production is constrained by the respective constraint. All constraints are transformed from the industry-country-time level to the country-time level using input-output tables and the share of consumption that each industry contributes to the final household consumption of a particular product. *China Dependence* represents the share of inputs to produce product p in country c that are imported from China in 2019. *Lockdown Stringency* measures the severity of lockdown measures implemented in China’s top-5 exporting provinces. Non-reported controls include the other perceived constraints to production (*Labor*, *Financial*, *Equipment*, and *Other*) and, in addition, the interaction of *Energy Inflation* and *Energy Use*. *Energy Inflation* is the country-time level CPI index for energy. *Energy Use* is a product-country pair’s energy input before the COVID-19 pandemic, measured in 2019 and scaled by the country’s total energy use. Standard errors are double-clustered at the country and quarterly level. We report standard errors in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

in the most stringent specification (Column (7)), providing evidence that the experience channel plays an important role in shaping household inflation expectations. Importantly, a positive correlation remains even after controlling for the experience channel, which suggests that the news channel also contributes to shaping household inflation expectations.

Overall, these results show that supply chain disruptions are positively associated with household inflation expectations. Based on the estimates in Column (6), a one standard deviation higher supply chain constraint in 2021 increases the share of households who believe that prices will increase more rapidly by 5pp, which is sizable given that the average share of households who think that prices will increase more rapidly is 21% in 2021.

To further substantiate the causal link between supply chain disruptions and rising household inflation expectations, we again run an IV estimation following our approach from Section 3.1. As before, we use the interaction between a market’s *China Dependence*_{pc} and

Lockdown Stringency_t as our instrumental variable. The dependent variable here is the share of households that believe consumer prices will increase more rapidly. [Table 5](#) presents the results. The IV estimated coefficients confirm the positive, plausibly causal, effect of an increase in the prevalence of reported supply chain frictions on inflation expectations.

Household-quarter level analysis. The second set of tests is based on the *household-quarter level* data from ECB’s CES, which allows us to observe households’ short-term (one-year ahead) and longer term (three-year ahead) inflation expectations. Consequently, we employ the following two dependent variables. First, a dummy variable set to one if household h anticipates a significant price increase over the next 12 months. Second, a dummy variable set to one if household h expects a substantial price rise during the 12-month period starting two years from now and ending three years from now.

To formally gauge the impact of supply chain disruptions on inflation expectations at the household-quarter level, we estimate the following specification:

$$\begin{aligned}\hat{\pi}_{hct}^e = & \beta_1 \text{Material}_{ct} + \beta_2 \text{Food Inflation}_{ct} + \beta_3 \text{Energy Inflation}_{ct} + \beta_4 \text{Core Inflation}_{ct} \\ & + \beta_5 \text{High Perception}_{hct} + \text{Other Constraints}_{ct} + \mu_{hc} + \epsilon_{hct},\end{aligned}\tag{4}$$

where h is a household, c is a country, and t is a quarter. As in the previous tests, we control for realized inflation and alternatively for households’ perception about inflation in the last 12 months (now at the household-time level).

The estimation results in [Table 6](#) confirm the positive association between supply chain constraints and households’ inflation expectations, both for their short-term (Panel A) and long-term (Panel B) expectations. For instance, the results in Column (5) of Panel A suggest that increasing the share of firms reporting material frictions from the 10th to the 90th percentile during the COVID-19 period leads to a 9.5pp higher probability for a household to believe prices will increase a lot in the following year. This corresponds to 31% of the average share of households thinking inflation will increase a lot. Similarly, the results in

Panel A: Short-Term Expectations ($\hat{\pi}_{hct}^{e,ST}$)	(1)	(2)	(3)	(4)	(5)	(6)
Material _{ct}	0.951*** (0.037)	0.593*** (0.034)	0.296*** (0.041)	0.261*** (0.041)	0.281*** (0.059)	0.110** (0.050)
Food Inflation _{ct}		1.715*** (0.050)	1.359*** (0.050)	0.949*** (0.067)	1.032*** (0.088)	
Energy Inflation _{ct}			0.192*** (0.011)	0.175*** (0.011)	0.158*** (0.013)	
Core Inflation _{ct}				1.468*** (0.201)	1.731*** (0.207)	
Perceived (realized) Inflation _{hct}						1.178*** (0.030)
Observations	126,080	126,080	126,080	126,080	126,080	126,080
R-squared	0.512	0.526	0.530	0.530	0.531	0.539
Panel B: Long-Term Expectations ($\hat{\pi}_{hct}^{e,LT}$)	(1)	(2)	(3)	(4)	(5)	(6)
Material _{ct}	0.242*** (0.019)	0.157*** (0.020)	0.097*** (0.023)	0.082*** (0.024)	0.110*** (0.038)	0.100*** (0.034)
Food Inflation _{ct}		0.410*** (0.037)	0.338*** (0.040)	0.160*** (0.061)	0.212*** (0.071)	
Energy Inflation _{ct}			0.039*** (0.009)	0.031*** (0.009)	0.025*** (0.010)	
Core Inflation _{ct}				0.636*** (0.162)	0.747*** (0.173)	
Perceived (realized) Inflation _{hct}						0.518*** (0.023)
Observations	126,080	126,080	126,080	126,080	126,080	126,080
R-squared	0.498	0.499	0.499	0.500	0.500	0.504
Other constraints					✓	✓
Household FE	✓	✓	✓	✓	✓	✓

Table 6: Supply chain constraint pass-through to household inflation expectations: Household-level evidence. This table presents estimation results from Specification (4). The subscript notation is defined as follows: h is a household, c is a country, and t is a quarter. The dependent variables are a household-time level dummy equal to one if household h believes prices will increase a lot over the next 12 month in Panel A and equal to one if household h believes prices will increase a lot over the 12-month period between current year+2 and current year+3 in Panel B. *Material*, *Labor*, *Financial*, *Equipment*, and *Other* measure the share of firms that indicate that their production is constrained by the respective constraint. All constraints are transformed from the industry-country-time level to the country-time level using the share of consumption that each industry contributes to the final household consumption. Non-reported controls include the other perceived constraints to production (*Labor*, *Financial*, *Equipment*, and *Other*) in Columns (5)–(6). *Food Inflation*, *Energy Inflation*, and *Core Inflation* are the country-time level CPI indices for food, energy, and core, respectively. *Perceived (realized) Inflation* is household h 's perception about the inflation over the last 12 months. Standard errors are clustered at the country-demographics level and are reported in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

Column (6) suggest a 4pp higher probability for a household to believe prices will increase a lot in the following year, corresponding to 14% of the average share of households thinking inflation will increase a lot.

Moreover, we observe a similar pattern as in the country-level analysis: controlling for the experience channel—through realized and perceived inflation—reduces the size of the effect, indicating that the experience channel plays an important role. However, a correlation persists even in the most stringent specifications, again suggesting that the news channel also contributes to shaping household inflation expectations.

The results in Panel B for long-term household inflation expectations show a qualitatively similar but a quantitatively smaller effect to that for short-term expectations. However, when controlling for realized inflation and households’ perceptions of past inflation, the two magnitudes become more comparable, suggesting that the experience channel exerts a stronger influence on short-term expectations, while the effect of the news channel seems to be more uniform across short-term and long-term expectations. This finding suggests an important role of the news channel in the unanchoring of household inflation expectations, which we explore next.

Household-quarter level analysis with interactions. In the third set of tests, we extend our analysis at the *household-quarter level* to explore the mechanisms through which the COVID-induced supply shocks shaped households’ inflation expectations. Specifically, we augment Specification (4) with two additional explanatory variables that serve as proxies for (i) households’ awareness of realized inflation during the initial cost-push phase, and (ii) households’ exposure to salient information about supply chain disruptions, conveyed through news media, peer discussions, interactions with employers, and similar channels.

Households with greater awareness of inflationary pressures caused by supply-side frictions are more likely to incorporate these perceptions into their inflation expectations (Link et al., 2024). To capture this awareness, we calculate the *within-household* correlation between households’ reported point estimates of headline inflation over the previous 12 months

and actual inflation rates for the period 2020:Q2–2022:Q4. Using this metric, we construct a binary variable, $Awareness_{hc}$, which equals one for households whose correlation exceeds the sample median.

The news channel suggests that households’ exposure to salient information about supply chain shocks influences their inflation expectations. To assess this exposure, we leverage Google Trends data—a widely used proxy for information acquisition in the social sciences (Choi and Varian, 2012; Korenok et al., 2022; Link et al., 2024; Fetzer et al., 2021).⁸ Specifically, we construct the variable $Google_{ct}$, which measures the intensity of Google searches for “delays in shipping” at the country-level, serving as a proxy for households’ exposure to and engagement with salient information about supply-side shocks.⁹ For this analysis, we focus on Germany, Italy, France, and Spain—the European countries with a sufficient volume of relevant searches.¹⁰

The coefficient for $Material_{ct} \times Awareness_{hc}$ in Columns (1) of Table 7 show that households more aware of realized inflation during the initial cost-push phase of the COVID-19 supply shock expect a more significant increase in CPI growth in response to escalating supply chain constraints. Column (2) confirms this result for a specification in which we additionally control for country-quarter fixed effects, which account for other country-specific factors influencing household inflation expectations, including realized inflation. Column (3) highlights a stronger correlation between reported supply chain disruptions and household inflation expectations in countries with greater exposure to salient information about supply

⁸Google Trends quantifies the search intensity for specific terms as a relative measure of search interest, where a value of 100 represents the peak popularity of the term for the specified region and time.

⁹This variable reflects heightened awareness and concern that drive the demand for additional information. Unlike metrics based on news article counts, it captures a wider range of information channels, including informal interactions with coworkers, peers, and social networks.

¹⁰We search for “Lieferschwierigkeiten” and “Lieferengpasse” for Germany, “tempi consegna” for Italy, “tiempo entrega” for Spain, and “délai de livraison” for France. These words maximize the number of searches available.

Dependent variable: $\hat{\pi}_{hct}^{e,ST}$	(1)	(2)	(3)	(4)	(5)
$Material_{ct}$	-0.461*** (0.052)		0.067 (0.081)	-0.260** (0.110)	
$Material_{ct} \times Awareness_{hc}$	1.547*** (0.048)	1.209*** (0.047)		0.694*** (0.152)	0.503*** (0.120)
$Material_{ct} \times Awareness_{hc} \times Google_{ct}$				1.408*** (0.275)	1.308*** (0.220)
$Google_{ct}$			-0.254*** (0.033)	-0.230*** (0.035)	
$Material_{ct} \times Google_{ct}$			0.882*** (0.138)	0.099 (0.177)	
$Awareness_{hc} \times Google_{ct}$				-0.089 (0.057)	-0.172*** (0.042)
$Food\ Inflation_{ct}$	1.020*** (0.084)		1.205*** (0.097)	1.156*** (0.093)	
$Energy\ Inflation_{ct}$	0.139*** (0.013)		0.095*** (0.018)	0.090*** (0.017)	
$Core\ Inflation_{ct}$	2.027*** (0.202)		2.476*** (0.282)	2.695*** (0.268)	
$Perceived\ (realized)\ Inflation_{hct}$		0.849*** (0.028)			0.841*** (0.026)
Observations	122,096	122,096	106,144	102,551	103,088
R-squared	0.534	0.554	0.536	0.539	0.556
Other constraints	✓		✓	✓	
Country-time FE		✓			✓
Household FE	✓	✓	✓	✓	✓

Table 7: Supply chain constraint pass-through to household inflation expectations: Interactions with household characteristics. This table presents estimation results from Specification (4). The subscript notation is defined as follows: h is a household, c is a country, and t is a quarter. The dependent variable is a household-time level dummy equal to one if household h believes prices will increase a lot over the next 12 month. *Material*, *Labor*, *Financial*, *Equipment*, and *Other* measure the share of firms that indicate that their production is constrained by the respective constraint. All constraints are transformed from the industry-country-time level to the country-time level using the share of consumption that each industry contributes to the final household consumption. *Awareness* is a dummy equal to one for households with an above median within household correlation between realized inflation over the last 12 months and the household’s inflation estimate for the last 12 months. *Google* is a country-time level variable measuring the intensity of Google searches for “delays in shipping” (in the respective country’s language). Non-reported controls include the other perceived constraints to production (*Labor*, *Financial*, *Equipment*, and *Other*) in Columns (1), (3), and (4). *Food Inflation*, *Energy Inflation*, and *Core Inflation* are the country-time level CPI indices for food, energy, and core, respectively. *Perceived (realized) Inflation* is household h ’s perception about the inflation over the last 12 months. Standard errors are clustered at the country-demographics level and are reported in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

chain disruptions as reflected in the significant coefficient on $Material_{ct} \times Google_{ct}$.

Finally, Columns (4) and (5) report results for specifications including interaction terms of $Material_{ct}$ jointly with both $Awareness_{hc}$ and $Google_{ct}$. The coefficients show that households with high awareness about realized inflation during the initial cost-push phase expect even

higher future inflation rates in response to supply chain shocks in countries with greater exposure to salient information about supply chain disruptions. These findings align with recent research showing an increase in the degree of attention and awareness about the aggregate price level for higher levels of inflation (Cavallo et al., 2017; Bracha and Tang, 2022; Korenok et al., 2022; Pfäuti, 2022; Weber et al., 2023). They are also consistent with Link et al. (2024), which shows that consumers more attentive to and informed about realized inflation tend to have inflation expectations that deviate more strongly upward from professional forecasts than those of less attentive individuals.

Table OA.1 shows that the results from Table 7 are robust to including interaction terms between the variable $Awareness_{hc}$ and the different inflation categories—namely, food, energy, and core inflation—as well as perceived inflation.

In sum, the findings in this section indicate that the supply chain pressures in the period after the outbreak of the COVID-19 pandemic influenced household inflation expectations upwards through *both* the experience and the news channel.

4 Generalization into broad-based inflation

We now consider the next of our hypotheses that higher household inflation expectations may be associated with a lower price elasticity of demand as firms can hide behind the aggregate costs and price uncertainty to sustain higher markups without risking a considerable decline in sales. This dynamic provides even firms not affected by supply-side constraints the leeway to raise prices, potentially contributing to a broader generalization of inflation.

Baseline spillover analysis. To isolate and test this mechanism, we compare the CPI growth in product-country pairs (hereafter termed “markets”) not materially affected by supply chain disruptions, across countries with varying degrees of aggregate (country-time level) growth in inflation expectations. Specifically, we isolate the impact on the CPI growth of service-based products, which were largely unaffected by supply chain constraints during

the pandemic, across countries that exhibit varying increases in inflation expectations. To this end, we estimate the following “spillover specification”:

$$\begin{aligned}
CPI\ Growth_{pct+1} = & \beta_1 Service_{pc} \times High\ Infl\ Exp_c + \sum_{\tau=20,21,22} \beta_{2\tau} Service_{pc} \times Year_{\tau} \\
& + \sum_{\tau=20,21,22} \beta_{3\tau} Service_{pc} \times High\ Infl\ Exp_c \times Year_{\tau} \\
& + Controls + \nu_{ct} + \theta_{pc} + \epsilon_{cpt},
\end{aligned} \tag{5}$$

where p is a product, c is a country, and t is a quarter. The dependent variable is again the one-quarter ahead annual CPI growth for a product-country pair and $Year$ is a set of year dummy variables. $Service_{pc}$ is the time-invariant contribution of service sectors to the consumption of product p in country c .¹¹ $High\ Infl\ Exp_c$ is an indicator equal to one if the increase in the share of households expecting prices to rise more rapidly is above the median in a country between 2021:Q1 and 2022:Q1—the period during which household inflation expectations rose substantially in Europe (see Figure 3). Figure OA.4 shows that in countries with high inflation expectations, the distribution of the growth in the share of households expecting prices to rise more rapidly has a notably thicker right tail, indicating a larger share anticipating steep price increases.

We also include country-time and product-country fixed effects, as well as the following set of control variables: the constraints to production other than the material constraint mostly relevant for manufacturing firms ($Labor_{ct}$, $Financial_{ct}$, and $Other_{ct}$) interacted with the three year dummies, and $Energy\ Inflation_{ct}$ interacted with the $Service_{pc}$ variable and the three year dummies. Finally, we exclude the product “Energy” from the sample. Controlling

¹¹We use the BCS classification to identify service sectors and obtain the service sector contribution to consumption from the COICOP-CPA matrix from Cai and Vandyck (2020).

for the $Energy\ Inflation_{ct}$ interactions and excluding the product “Energy” alleviates concerns about bias coming from the rise in energy inflation during our sample period—due to manifestation of pent-up demand in 2021 and notably after the Russian invasion of Ukraine in March 2022, which severely affected energy supply to several European countries.

The estimation results in Table 8 present evidence consistent with a generalization of inflation going from markets directly affected by supply-side constraints to more service-oriented markets, which are less affected, or not affected at all, by these constraints. In line with supply chain constraints being passed through to higher consumer prices in the manufacturing sector, the first three rows of Column (1) show that more service-oriented markets have a lower CPI growth than more manufacturing-based markets in the same country. However, the coefficient for the interaction of $Service_{pc} \times High\ Infl\ Exp_c$ with the year 2022 confirms that the CPI growth of service-oriented markets tends to be higher in 2022 when inflation expectations significantly increased in the respective country, relative to similar markets in countries that experienced a less pronounced increase in inflation expectations. Consistent with this catch-up in price increases among service-sector firms relative to manufacturing firms, Figure OA.5 shows that while the gap between service and manufacturing inflation initially widened after 2020, it narrowed more toward 2022 in high-inflation-expectation countries than in countries with more anchored expectations.

Moreover, the coefficients for $Service_{pc} \times Energy\ Inflation_{ct}$ interacted with the three post-COVID years in Column (1) of Table 8 indicate that energy prices do not seem to substantially affect the differential CPI growth rates between service- and manufacturing-oriented markets. This observation implies that energy prices are unlikely to be the driver of the spillover and generalization of inflation that we are documenting.

In Columns (2)–(4), we conduct three tests to rule out that the generalization of inflation is merely a result of demand shocks. In Column (2), we additionally include product-country-time fixed effects, using the 1-digit COICOP as product category. These fixed effects control for the impact of demand shocks affecting broad product categories. In Column (3), we

Dependent variable: CPI Growth _{pc,t+1}	(1)	(2)	(3)	(4)
Specification	Full Sample Baseline	Demand 1-Digit	Lockdown Intensity	Household Expenditure
Service _{pc} × 2020 _t	−0.155 (0.607)	−0.728 (0.539)	0.020 (0.721)	−0.075 (0.630)
Service _{pc} × 2021 _t	−2.304*** (0.731)	−3.515*** (0.744)	−2.740*** (0.845)	−2.167** (0.751)
Service _{pc} × 2022 _t	−5.683*** (1.033)	−4.564*** (0.999)	−5.678*** (0.946)	−5.581*** (1.049)
Service _{pc} × High Infl Exp _c × 2020 _t	−0.922 (0.670)	−0.804 (0.880)	−0.914 (0.660)	−0.984 (0.673)
Service _{pc} × High Infl Exp _c × 2021 _t	0.711 (0.761)	−0.239 (0.930)	0.208 (0.741)	0.617 (0.765)
Service _{pc} × High Infl Exp _c × 2022 _t	2.714** (0.997)	2.957** (1.157)	2.491** (0.985)	2.557** (0.986)
Service _{pc} × Energy Inflation _{ct} × 2020 _t	0.105* (0.050)	0.128** (0.057)	0.096* (0.049)	0.103* (0.051)
Service _{pc} × Energy Inflation _{ct} × 2021 _t	−0.002 (0.037)	0.068 (0.040)	0.007 (0.038)	0.006 (0.040)
Service _{pc} × Energy Inflation _{ct} × 2022 _t	−0.007 (0.033)	0.011 (0.032)	0.006 (0.034)	−0.001 (0.036)
Service _{pc} × Energy Inflation _{ct}	0.033 (0.031)	0.022 (0.029)	0.021 (0.032)	0.027 (0.034)
Energy Use _{pc} × Energy Inflation _{ct}	1.394** (0.504)	1.186*** (0.234)	1.387** (0.522)	1.346** (0.482)
Observations	8,515	7,678	8,515	8,515
R-squared	0.477	0.768	0.522	0.478
Other constraints	✓	✓	✓	✓
Other constraints interacted	✓	✓	✓	✓
Lockdown intensity control			✓	
Household expenditure control				✓
Country-time FE	✓	✓	✓	✓
Product-country FE	✓	✓	✓	✓
1-digit product-country-time FE		✓		

Table 8: Pass-through of supply chain constraints to generalized inflation. This table presents estimation results from Specification (5). The subscript notation is defined as follows: p is a product, c is a country, and t is a quarter. The dependent variable is the one-quarter ahead annual CPI growth at the product-country level. *Material*, *Labor*, *Financial*, *Equipment*, and *Other* measure the share of firms that indicate that their production is constrained by the respective constraint. All constraints are transformed from the industry-country-time level to the product-country-time level using the share of consumption that each industry contributes to the final household consumption. *Service* is the time-invariant contribution of service sectors to the consumption of product p in country c . *High Infl Exp* is an indicator equal to one if the increase in the share of households expecting that prices will rise more rapidly is above the median in a country between 2021:Q1 and 2022:Q1. Non-reported controls include the other perceived constraints to production (*Labor*, *Financial*, *Equipment*, and *Other*) uninteracted and, in addition, these other constraints interacted with the three year dummies. In Column (3), we additionally control for the country-level severity of lockdown measures in 2021, as well as for its double and triple interactions with *Service* and the different year dummies. In Column (4), we additionally control for the final consumption expenditure of households at the product-country-time level. *Energy Inflation* is the country-time level CPI index for energy. *Energy Use* is an industry-country pair’s energy input before the COVID-19 pandemic, measured in 2019 and scaled by the country’s total energy use. We exclude the product “Energy” from the regression. Standard errors are double-clustered at the country-product and quarterly level and are reported in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

Dependent variable: CPI Growth _{pct+1}	(1)	(2)	(3)	(4)
Sample	High Mkt Power Markets	Low Mkt Power Markets	High Bargaining Countries	Low Bargaining Countries
Service _{pc} × High Infl Exp _c × 2020 _t	2.028 (1.343)	−1.681 (2.664)	−1.016 (0.854)	−0.272 (2.817)
Service _{pc} × High Infl Exp _c × 2021 _t	0.791 (1.728)	−3.235 (2.482)	−0.924 (1.142)	0.381 (1.651)
Service _{pc} × High Infl Exp _c × 2022 _t	5.228** (2.439)	−0.753 (2.868)	2.316* (1.374)	3.947** (1.624)
Observations	3,053	2,875	4,545	2,685
R-squared	0.803	0.790	0.738	0.812
Other constraints	✓	✓	✓	✓
Other constraints interacted	✓	✓	✓	✓
Country-time FE	✓	✓	✓	✓
Product-country FE	✓	✓	✓	✓

Table 9: Pass-through of supply chain constraints to generalized inflation. This table presents estimation results from Specification (5). The subscript notation is defined as follows: p is a product, c is a country, and t is a quarter. The dependent variable is the one-quarter ahead annual CPI growth at the product-country level. *Material*, *Labor*, *Financial*, *Equipment*, and *Other* measure the share of firms that indicate that their production is constrained by the respective constraint. All constraints are transformed from the industry-country-time level to the country-time level using the share of consumption that each industry contributes to the final household consumption. *Service* is the time-invariant contribution of service sectors to the consumption of product p in country c . *High Infl Exp* is an indicator equal to one if the increase in the share of households expecting that prices will rise more rapidly is above the median in a country between 2021:Q1 and 2022:Q1. *High Market Power* markets are defined as industry-country pairs with an above median average markup. *High Collective Bargaining* countries are countries with a share of employees covered by a collective agreement as a proportion of the number of eligible employees above 75%. Non-reported controls include the other perceived constraints to production (*Labor*, *Financial*, *Equipment*, and *Other*) uninteracted and, in addition, these other constraints interacted with the three year dummies. *Energy Inflation* is the country-time level CPI index for energy. *Energy Use* is an industry-country pair’s energy input before the COVID-19 pandemic, measured in 2019 and scaled by the country’s total energy use. We exclude the product “Energy” from the regression. Standard errors are double-clustered at the country-product and quarterly level and are reported in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

further control for the country-level severity of lockdown measures in 2021 (using OxCGRT’s COVID-19 Stringency Index) as a proxy for pent-up demand for services. Finally, in Column (4), we control for the final consumption expenditure of households at the product-country-time level, employing data from Eurostat at the 2-digit COICOP level. This variable helps control for shifts in demand across different product categories. The spillover of inflation to services sectors in high inflation expectation countries is not materially affected when we control for these proxies of demand.

Influence of market power. Columns (1) and (2) of Table 9 show estimation results in the

subsamples of *High Market Power* and *Low Market Power* markets, which consist of industry-country pairs with an above and below median average markup in 2018, respectively.¹² The results show that the generalization into broad-based inflation is driven by markets with high market power, consistent with service firms using their pricing power to extract higher markups in an environment of elevated household inflation expectations—thereby enabling inflation to spread more broadly.

Testing for the influence of labor costs. Another potential concern is that the higher price levels in service-oriented markets in countries with rapidly rising inflation expectations might simply stem from firms anticipating a steeper rise in labor costs, driven by heightened household inflation expectations and subsequent wage hike demands (e.g., see [Reis, 2023](#)). To address this concern, we employ the OECD/AIAS ICTWSS database, which includes an adjusted collective bargaining coverage rate, defined as the number of employees covered by a collective agreement in force as a proportion of the total number of employees minus the number of employees legally excluded from the right to bargain.

We then re-estimate Specification (5) separately in the subsample of high collective bargaining countries (collective bargaining coverage rate above 75%) and low collective bargaining countries (collective bargaining coverage rate below 75%).¹³ Columns (3) and (4) of [Table 9](#) report the results for this sample split, showing that the estimated coefficients are similar across the two subsamples, suggesting that the generalization into broad-based inflation does not seem to be driven by firms anticipating a rise in labor costs.

Controlling for spillovers along the supply chain. Yet another potential concern is that the observed generalization of inflation from markets directly affected by supply-side

¹²We obtain average markups at the industry-country level from the 9th vintage of the CompNet database.

¹³We set the threshold for the sample split to 75% since the distribution of the collective bargaining coverage rate across countries is clustered into two distinct groups as shown in [Figure OA.6](#): countries that all have a coverage ratio below 57% and countries that all have a coverage ratio above 77%.

Dependent variable: CPI Growth $_{pct+1}$	(1)	(2)	(3)	(4)
Service $_{pc} \times$ High Infl Exp $_c \times 2020_t$	−1.135 (0.790)	−1.220 (0.777)	−1.127 (0.791)	−1.187 (0.777)
Service $_{pc} \times$ High Infl Exp $_c \times 2021_t$	0.080 (0.752)	0.116 (0.756)	0.100 (0.752)	0.135 (0.756)
Service $_{pc} \times$ High Infl Exp $_c \times 2022_t$	2.386** (1.085)	2.379** (1.076)	2.424** (1.083)	2.421** (1.074)
Energy Use $_{pc} \times$ Energy Inflation $_{ct}$	1.401*** (0.252)	1.073** (0.486)	1.393*** (0.252)	1.064** (0.484)
Material Supply $_{pcx} \times 2020_t$	0.024 (0.082)	0.088 (0.084)	0.012 (0.071)	0.043 (0.072)
Material Supply $_{pcx} \times 2021_t$	0.141** (0.056)	0.118** (0.057)	0.221*** (0.053)	0.199*** (0.053)
Material Supply $_{pcx} \times 2022_t$	0.029 (0.067)	0.010 (0.068)	0.070 (0.056)	0.057 (0.058)
Energy Use Supply $_{pc} \times$ Energy Inflation $_{cx} \times 2020$		−1.238 (2.349)		−0.979 (2.331)
Energy Use Supply $_{pc} \times$ Energy Inflation $_{cx} \times 2021$		1.688 (2.368)		1.193 (2.360)
Energy Use Supply $_{pc} \times$ Energy Inflation $_{cx} \times 2022$		−1.199 (2.021)		−1.477 (2.021)
Timing of supply constraint	$x = t$	$x = t$	$x = t - 1$	$x = t - 1$
Observations	8,515	8,515	8,515	8,515
R-squared	0.524	0.533	0.524	0.533
Other constraints	✓	✓	✓	✓
Other constraints interacted	✓	✓	✓	✓
Country-time FE	✓	✓	✓	✓
Product-country FE	✓	✓	✓	✓

Table 10: Pass-through of supply chain constraints to generalized inflation with controls for spillovers along the supply chain. This table adjusts the baseline analysis from Table 8 by including controls for potential supply chain spillovers. Column (1) introduces interactions with *Material Supply*, which measures the share of firms that indicate that their production is constrained by material input constraints in year $x = t$ among the suppliers that provide input goods to firms that sell product p in country c in year t . Column (2) further includes controls for the energy cost exposure in year t of the suppliers that provide input goods to firms that sell product p in country c in year t . Columns (3) and (4) replicate the analysis of Columns (1) and (2), respectively, but with variables lagged by one year (i.e., $x = t - 1$). Standard errors are double-clustered at the country-product and quarterly level and are reported in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

constraints to those less impacted is, at least partially, driven by spillover effects along the supply chain. Specifically, disruptions in production among upstream suppliers might cascade downstream, influencing the prices of final goods sold to consumers. This dynamic might bias our results if more service-oriented product-country pairs tend to be initially less impacted by supply-side shocks in the early post-COVID period, yet are indirectly affected later due to their reliance on upstream suppliers who experience these shocks.

To check whether our findings are affected by this dynamic, we modify the analysis from

Table 8 by including controls for such supply shock spillovers along the supply chain. To this end, we employ $Material\ Supply_{pct}$, which measures the share of suppliers facing material shortages in year t , supplying to firms selling product p in country c in the same year. The results in Column (1) of Table 10 indicate that, although increased material input constraints among suppliers are associated with higher price growth in the products they supply, the generalization effect remains robust.

Column (2) shows that the inflation generalization effect to the services sector is also robust to controlling for spillovers along the supply chain caused by energy shocks. To this end, we add the control $Energy\ Use\ Supply_{pc} \times Energy\ Inflation_{ct}$, which captures the impact of rising energy costs on the production of suppliers (we construct this variable as the product between the energy usage of suppliers and the growth in energy costs). In a last step, we incorporate again both supply chain spillover controls, but apply a one-quarter lag to accommodate a potential delay in the transmission of supply shocks through the supply chain. Columns (3) and (4) confirm that the generalization effect is robust to these lagged specifications.

Taken together, our evidence is consistent with inflation initially driven by supply-side shocks becoming increasingly broad-based over time—shifting from manufacturing to services—through firms’ pricing responses to elevated household inflation expectations.

5 The role of firms’ pricing behavior

In this section, we employ two sets of tests to further examine the role of firms’ pricing behavior in the generalization of inflationary pressures and how such generalization is shaped by household inflation expectations, firms’ pricing power, and their interaction.

In Section 5.1, we use firm-level financial data from Compustat Global and earnings call transcripts analyzed with a LLM to link elevated household inflation expectations to firms’ ability to sustain higher markups through increased pricing power. As outlined in Section

2.2, elevated household inflation expectations can result in lower price elasticity of demand, as evidenced by references to increased pricing power and resilient demand in company earnings call transcripts. In Section 5.2, we analyze how firms’ pre-COVID pricing power influences their ability to raise markups in response to supply-side shocks and changes in household inflation expectations during the COVID-19 pandemic period.

5.1 Drivers of firms’ pricing behavior and pricing power

To assess firms’ pricing behavior in the post-COVID inflationary environment, we leverage firm-level data from Compustat Global and estimate firm markups following De Loecker et al. (2020). Their approach relies on the insight that the output elasticity of a variable production factor is only equal to its expenditure share in total revenue when price equals marginal cost of production. Under any form of imperfect competition, however, the relevant markup drives a wedge between the input’s revenue share and its output elasticity.

To explore the factors influencing firms’ pricing behavior, we analyze transcripts of companies’ earnings calls, which are key events where executives provide insights into a firm’s financial health, future outlook, and—most importantly for our analysis—strategic decisions, including pricing policies. We obtain earnings call transcripts from the LSEG Workspace Transcripts & Briefs database. Our sample includes 27,163 transcripts from 2,414 European firms, covering all quarters from 2019:Q1 to 2023:Q4. Each transcript consists of a presentation by company executives, followed by a Q&A session with analysts. To ensure consistency, we retain only the presentation portion, as it follows a standardized format across firms and focuses on comparable company-specific topics. We further segment each transcript by speaker to reduce the LLM input length and analyze patterns within a call. The total number of speaker sections across all transcripts is 120,305, resulting in an average of 4.43 speaker sections per transcript.

We employ an LLM to identify whether firms discuss price increases and the factors driving them, leveraging the model’s ability to process large volumes of textual data while

preserving context and capturing relationships within the text (Vaswani et al., 2017).¹⁴ Specifically, we use OpenAI’s GPT-4o model and interact with it through the ChatCompletion API endpoint.¹⁵ To ensure consistent formatting of the model’s output, we specify a structured JavaScript Object Notation (JSON) output schema.¹⁶ Each API request includes the following prompt, along with a speaker section of an earnings call transcript:

You are an economic analyst specializing in extracting nuanced insights from textual data. Your specialization is in understanding firms’ pricing power, input costs and frictions, and customer demand in an inflationary environment. You will be given a section of an earnings call transcript where the dialogue is segmented by speaker. Based only on the text provided, you must assign two scores: score one and score two.

Score one:

- ‘1’ if the company experiences or expects rising pricing power.
- ‘0’ if the company does not experience or expect rising pricing power.
- ‘na’ if the company does not discuss its pricing power.

Score two (one or more values):

- ‘1’ if the company experiences or expects resilient demand.
- ‘2’ if the company experiences or expects supply-chain disruptions.
- ‘3’ if the company experiences or expects rising labor costs.
- ‘4’ if the company experiences or expects rising energy costs.
- ‘na’ only if none of the other options are assigned.

The values should only include the score and no additional text.

Based on the LLM output, we construct a set of variables to investigate the mechanisms linking firms’ pricing behavior to elevated household inflation expectations and firms’ pricing power.

¹⁴Traditional text analysis techniques—such as keyword extraction, word counting, and rule-based sentiment analysis—often struggle to preserve context over long sequences and to capture complex relationships between words.

¹⁵We set the temperature to 0 to ensure deterministic behavior, meaning the model will always select the most probable next token in its output. This behavior is preferred for a classification task such as ours.

¹⁶The structured output feature enables users to define the expected format of the model’s response.

To capture firms’ general perception of their ability to raise prices, we define the baseline variable *Pricing Power Overall*_{*ijct*} as the number of transcript sections in which executives of firm *i* in industry *j* in country *c* during quarter *t* report experiencing or expecting rising pricing power (i.e., score one equals 1), irrespective of the underlying justification. In line with our hypothesized transmission mechanism that elevated household inflation expectations are associated with lower consumer price sensitivity, mentions of pricing power are significantly more common in countries characterized by higher household inflation expectations. Firms in high-expectation countries report a size-adjusted average of 1.04 mentions of pricing power, compared to 0.97 in low-expectation countries, with the difference statistically significant ($t = 2.66$).¹⁷

To more directly assess whether firms are able to maintain higher prices without significant losses in sales—indicative of lower demand elasticity—we construct the variable *Pricing Power & Resilient Demand*_{*ijct*}, which counts the number of transcript sections in which executives explicitly link their pricing power to resilient consumer demand, as identified by our LLM classification (i.e., score one equals 1 and score two includes value 1). Consistent with the baseline results, firms in high-expectation countries are significantly more likely to cite resilient demand when discussing pricing power (1.02 vs. 0.92; $t = 3.41$). This pattern reinforces the idea that elevated inflation expectations can support stronger firm pricing power by altering consumer behavior.

Next, we parametrically confirm that pricing power and resilient demand, associated with elevated household inflation expectations and indicative of lower price elasticity of demand, allow firms to charge relatively higher markups. For this analysis, we regress the estimated markup of firm *i* in industry *j* and country *c* in quarter $t + 1$ on our LLM-based pricing

¹⁷Recall that high inflation expectation countries are those where the increase in the share of households expecting prices to rise more rapidly between 2021:Q1 and 2022:Q1 is above the median.

power measures in quarter t , controlling for country-quarter fixed effects:

$$Markup_{ijct+1} = \alpha + \beta LLM_{ijct} + \psi_{ct} + \epsilon_{ijct}. \quad (6)$$

Panel A of [Table 11](#) presents the results. Column (1) shows that executives’ explicit discussions of pricing power during earnings calls are predictive of increased firm-level markups in the following quarter, thus validating our LLM-based classification. Column (2) shows that firms specifically highlighting resilient demand as a basis for their pricing power are able to charge relatively higher markups, supporting the idea that once elevated household inflation expectations reduce consumers’ price sensitivity, firms can leverage this environment to sustain higher markups.

In addition to demand-side drivers, an alternative source of firms’ pricing power in the post-COVID period could stem from scarcity-driven factors. Specifically, supply chain bottlenecks—while simultaneously raising input costs—may enhance firms’ ability to set higher prices, either directly due to reduced competitive pressures from limited product availability, or indirectly by elevating consumers’ inflation expectations, which firms could exploit more broadly as justification for price increases. To investigate this potential mechanism, we construct the variable *Pricing Power & Supply Chain*_{ijct} analogously to *Pricing Power & Resilient Demand*_{ijct}. This variable counts the number of transcript sections in which executives explicitly link their pricing power to supply chain disruptions. The results in Column (3) of [Table 11](#) indicate that firms citing supply chain frictions alongside pricing power do not exhibit significantly higher markups, suggesting that supply-side scarcity alone may be a weaker basis for firms to raise prices.

Similarly, we examine whether labor and energy constraints influence firms’ pricing power in the post-COVID inflationary environment. To this end, we construct the measures *Pricing Power & Labor*_{ijct} and *Pricing Power & Energy*_{ijct}, which count instances in earnings call transcripts where executives link their pricing power to rising labor costs or elevated energy

prices, respectively. Columns (4) and (5) show that references to labor have no significant effect, while energy costs are associated with relatively lower markups, suggesting that rising energy costs pose particular challenges for firms in passing through price increases to consumers.

Panel A Dependent variable: Markup _{ijct+1}	Overall (X=1)	X=Resilient Demand	X=Supply Chain	X=Labor	X=Energy
Pricing Power & X	0.029* (0.016)	0.034** (0.017)	−0.007 (0.020)	−0.015 (0.030)	−0.070*** (0.027)
Observations	5,992	5,992	5,992	5,992	5,992
R-squared	0.067	0.067	0.065	0.065	0.067

Panel B Dependent variable: Markup _{ijct+1}	Overall	X=Resilient Demand	X=Supply Chain	X=Labor	X=Energy
Pricing Power & X	0.054* (0.032)	0.065** (0.025)	−0.004 (0.041)	−0.037 (0.069)	−0.186** (0.078)
Pricing Power & X × Service × 2020	−0.049 (0.067)	−0.047 (0.039)	−0.037 (0.059)	−0.037 (0.192)	−0.035 (0.211)
Pricing Power & X × Service × 2021	0.048 (0.052)	0.059 (0.042)	0.039 (0.053)	0.174 (0.138)	−0.091 (0.125)
Pricing Power & X × Service × 2022	0.096* (0.050)	0.088*** (0.026)	0.086 (0.059)	0.005 (0.114)	−0.041 (0.117)
Observations	5,992	5,992	5,992	5,992	5,992
R-squared	0.082	0.082	0.083	0.078	0.084
Country-quarter FE	✓	✓	✓	✓	✓

Table 11: Drivers of firms’ pricing behavior and pricing power. Panels A and B present regression results where the dependent variable is a firm’s one-quarter-ahead markup. In Column (1), pricing power is measured as the total number of instances in which a firm discusses having pricing power. In Columns (2) to (5), pricing power is measured based on the number of instances attributed to each specific driver listed in the respective column. *High Infl Exp* is an indicator equal to one if the increase in the share of households expecting that prices will rise more rapidly is above the median in a country between 2021:Q1 and 2022:Q1. *Service* is an indicator variable equal to one if a firm is incorporated in a service sector, and zero otherwise. Standard errors are clustered at the industry-level and are reported in parentheses. *** p<0.01, ** p<0.05, * p<0.1.

Finally, we parametrically analyze how firms in the service and manufacturing sectors differ in their ability to sustain higher markups, and whether these differences change over time. For this analysis, we augment the specification from Panel A by introducing interaction terms with the dummy variable $Service_{ijc}$ —which equals one if firm i in sector j and

country c operates in a service industry—and the three post-COVID year dummies. The results in Panel B are consistent with the evidence on the generalization of inflation in [Section 4](#). Specifically, in 2022, among firms citing pricing power associated with resilient demand, service-sector firms were able to sustain relatively higher markups compared to manufacturing firms. This evidence indicates that once supply chain constraints subsided but household inflation expectations nevertheless remained elevated, service firms possessing pricing power leveraged resilient demand effectively, allowing them to catch up to manufacturing firms in terms of price increases.

Overall, this analysis supports the idea that elevated household inflation expectations, and the resulting increase in firms’ pricing power and reduced consumer price sensitivity, serve as a key transmission channel in facilitating the transition from localized to generalized inflationary pressures. These dynamics allow even firms initially unaffected by supply-side shocks to sustain higher markups.

5.2 Firms’ pricing behavior and pre-COVID pricing power

To further evaluate how firms’ pricing power interacts with elevated household inflation expectations in shaping firms’ markup strategies, we estimate the following triple-interaction specification at the firm-quarter level:

$$\begin{aligned}
Markup_{ijct+1} = & \sum_{\tau=20,21,22} \beta_{1\tau} Markup_{ijc}^{2018} \times Constraint_{jct} \times Year_{\tau} \\
& + \sum_{\tau=20,21,22} \beta_{2\tau} Markup_{ijc}^{2018} \times High\ Infl\ Exp_{ct} \times Year_{\tau} \\
& + \beta_3 Markup_{ijc}^{2018} \times Constraint_{jct} + \beta_4 Markup_{ijc}^{2018} \times High\ Infl\ Exp_{ct} \\
& + \sum_{\tau=20,21,22} \beta_{5\tau} Markup_{ijc}^{2018} \times Year_{\tau} + \beta_6 Markup_{ijc}^{2018} + \xi_{jct} + \epsilon_{ijct}, \quad (7)
\end{aligned}$$

where i is a firm, j is an industry, c is a country, and t is a quarter. The main coefficient of interest is $\beta_{2\tau}$, which captures the influence of pre-pandemic pricing power—proxied by $Markup_{ijc}^{2018}$, the firm-level markup measured at the end of 2018—on the generalization of inflationary pressures through the rise in household inflation expectations. $High\ Infl\ Exp_{ct}$ is a dummy variable that equals one if, in a given country-quarter, the share of households expecting consumer prices to rise more rapidly over the next 12 months exceeds the median level observed in that country between 2021:Q1 and 2022:Q1.

Moreover, $Constraint_{jct}$ is a vector encompassing the two supply-side constraints, $Material_{jct}$ and $Labor_{jct}$, both measured at the industry-country-time level. $Year$ is a set of dummy variables for 2020 (from Q2 onwards), 2021, and 2022, with 2019 again being the base year. Accordingly, the coefficient $\beta_{1\tau}$ captures how pre-pandemic pricing power shapes firms' responses to cost-push shocks, reflecting their ability to pass on supply-side constraints into higher markups.

To isolate the firm-level impact of pricing power on markup dynamics, we include industry-country-time fixed effects to absorb time-varying shocks that simultaneously impact all firms within a given industry and country, such as policy interventions or demand fluctuations. These fixed effects also account for sector-specific differences in markup levels, which arise due to variations in cost structures, particularly the balance between fixed and variable costs across industries.

Column (1) of [Table 12](#) presents the estimation results for the full sample of firms. Column (2) reports results for the subsample of manufacturing firms, which were most affected by pandemic-induced supply chain disruptions. Column (3) presents results for firms in the service sector, which were relatively unaffected by supply chain constraints but more exposed to labor constraints. Accordingly, for service sector firms, we employ the labor constraint variable ($Labor$) as control.

There are two key takeaways. First, the estimated coefficients for the interactions between $Markup_{ijc}^{2018}$ and the $Year$ dummies indicate that in countries where household inflation

Dependent variable: Markup _{ijct+1}	(1)	(2)	(3)	(4)	(5)	(6)
Sample	Full	Manufacturing	Services	Full	Manufacturing	Services
Material _{jct} × Markup _{ijc} ²⁰¹⁸	−0.003*** (0.001)	−0.003*** (0.001)			−0.003** (0.001)	
Markup _{ijc} ²⁰¹⁸ × 2020 _t	−0.141*** (0.051)	−0.126*** (0.037)	−0.107 (0.126)	−0.084*** (0.031)	−0.111*** (0.037)	−0.111 (0.074)
Markup _{ijc} ²⁰¹⁸ × 2021 _t	−0.154 (0.112)	−0.170** (0.076)	−0.154 (0.189)	−0.089* (0.046)	−0.142** (0.062)	−0.089 (0.130)
Markup _{ijc} ²⁰¹⁸ × 2022 _t	−0.290** (0.121)	−0.327*** (0.108)	−0.282* (0.165)	−0.164*** (0.049)	−0.192** (0.092)	−0.126 (0.107)
Material _{jct} × Markup _{ijc} ²⁰¹⁸ × 2020 _t	0.001 (0.001)	0.001 (0.001)			0.001 (0.001)	
Material _{jct} × Markup _{ijc} ²⁰¹⁸ × 2021 _t	0.004*** (0.001)	0.004*** (0.001)			0.004** (0.002)	
Material _{jct} × Markup _{ijc} ²⁰¹⁸ × 2022 _t	0.005*** (0.001)	0.005*** (0.001)			0.003* (0.002)	
Labor _{jct} × Markup _{ijc} ²⁰¹⁸	0.001 (0.001)		−0.003 (0.002)			−0.004** (0.002)
Labor _{jct} × Markup _{ijc} ²⁰¹⁸ × 2020 _t	0.001 (0.002)		0.001 (0.003)			0.001 (0.002)
Labor _{jct} × Markup _{ijc} ²⁰¹⁸ × 2021 _t	−0.001 (0.003)		0.001 (0.003)			0.001 (0.002)
Labor _{jct} × Markup _{ijc} × 2022 _t	−0.001 (0.002)		0.004 (0.003)			0.002 (0.002)
High Infl Exp _c × Markup _{ijc} ²⁰¹⁸	0.141*** (0.052)	0.129** (0.056)	0.098 (0.095)	0.150*** (0.051)		
High Infl Exp _c × Markup _{ijc} ²⁰¹⁸ × 2020 _t	0.070 (0.075)	0.056 (0.076)	0.004 (0.123)	0.017 (0.059)		
High Infl Exp _c × Markup _{ijc} ²⁰¹⁸ × 2021 _t	0.068 (0.083)	0.074 (0.073)	0.135 (0.161)	0.066 (0.058)		
High Infl Exp _c × Markup _{ijc} ²⁰¹⁸ × 2022 _t	0.161** (0.079)	0.176** (0.081)	0.207* (0.125)	0.118** (0.057)		
Markup _{ijc} ²⁰¹⁸	0.827*** (0.034)	0.855*** (0.029)	0.883*** (0.109)	0.797*** (0.033)	0.902*** (0.033)	0.943*** (0.069)
Observations	12,420	12,420	6,420	18,840	12,420	6,411
R-squared	0.801	0.800	0.621	0.765	0.797	0.619
Industry-country-time FE	✓	✓	✓	✓	✓	✓

Table 12: Firms’ pricing behavior and pre-COVID pricing power. This table presents estimation results from Specification (7). The subscript notation is defined as follows: i is a firm, j is an industry, c is a country, and t is a quarter. The dependent variable is a firm’s markup, which we estimate following De Loecker et al. (2020). *Material* and *Labor* measure the share of firms that indicate that their production is constrained by supply chain problems and by labor shortages at the industry-country-time level, respectively. *Markup*²⁰¹⁸ measures a firm’s markup in the fiscal year 2018. *High Infl Exp* is a dummy equal to one if the share of households in a country-quarter that believe consumer prices will increase more rapidly over the next 12 months has increased above the median level in a country between 2021:Q1 and 2022:Q1. Columns (1) and (4) are estimated in the full sample. Columns (2) and (5) are estimated in the sample of manufacturing firms. Columns (3) and (6) are estimated in the sample of firms operating in services. Standard errors are clustered at the industry-country level and reported in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

expectations did not materially increase, firms with greater pricing power at the onset of the pandemic experienced a relatively larger decline in markups during the pandemic period. Second, the estimated coefficients for the triple interactions between *High Infl Exp_c*, Markup²⁰¹⁸_{ijc}, and the *Year* dummies indicate that in countries where household inflation expectations rose more sharply, firms with greater pre-pandemic pricing power were able to sustain relatively higher markups in 2022.¹⁸

The interaction between high inflation expectations and firms' pricing power thus appears to contribute to the emergence of generalized inflation, spreading inflationary pressures across the broader economy. This conclusion is further supported by the finding that pricing power also allows firms in the service sector—where material-driven cost-push inflation is minimal—to sustain relatively higher markups in 2022 in countries with elevated household inflation expectations (see Column (3)).

Moreover, the estimated coefficients in Columns (1) and (2) for the interactions between *Material_{jct}*, Markup²⁰¹⁸_{ijc}, and *Year* suggest that firms with greater pre-pandemic pricing power were also more effective at passing increased material input costs to prices during the initial cost-push phase. Importantly, in a context where material input costs are increasing, even simply maintaining the same markup suggests that these firms were able to enhance their gross margins in absolute terms—and consequently, their absolute profits—per unit sold.¹⁹ The results in Column (3) provide no evidence that pricing power influences the cost-push pass-through of labor costs to inflation during the pandemic period in the services sector.

¹⁸These results align with [Konczal et al. \(2022\)](#), which finds that 2021 recorded the highest markups and the largest annual increase in the U.S. since 1955. Notably, firms with the highest pre-pandemic markups raised them the most during the pandemic period.

¹⁹Markups are defined as the ratio of price to marginal costs. Take, for instance, an initial markup of 1.5. If marginal costs rise from 1 to 2 due to supply-side shocks, the per-unit gross margin in absolute terms then grows from 0.5 ($= 1.5 \times 1 - 1$) to 1 ($= 1.5 \times 2 - 2$).

Finally, Column (4) replicates Column (1), focusing on the generalization of inflation through inflation expectations and therefore excluding the terms for $Material_{jct}$ and $Labor_{jct}$, which are associated with the cost-push channel. Meanwhile, Columns (5) and (6) isolate the cost-push channel by excluding terms related to the generalized markup shock driven by elevated inflation expectations, analyzing manufacturing and service firms separately. These tests confirm that the interaction of pricing power and elevated inflation expectations broadly amplifies inflationary pressures, while in the cost-push phase pricing power solely influences markup adjustments within the manufacturing sector.

6 Mechanisms driving the generalization of inflation

Our key empirical finding is that localized supply-side inflation can generalize into broad-based markups and inflation. What are the potential driving mechanisms?

Building on the search model from [Benabou and Gertner \(1993\)](#), we show in [Appendix OA.4](#) how the perception of a common cost shock, potentially associated with generalized inflation expectations, can drive higher markups and prices, particularly in sectors not directly impacted by the initial localized supply-side shock. In response to a supply shock, consumers must evaluate the extent to which individual firms are affected in order to make optimal decisions about their search efforts and subsequent consumption choices. If a supply shock is perceived as widespread—a common shock affecting many firms—consumers are less inclined to engage in costly search efforts for better deals because they anticipate uniformly higher prices across the market (see also [Fishman, 1996](#) and [Gaballo and Paciello, 2022](#)). This shift in behavior translates into higher reservation (acceptance) prices, particularly in sectors that are not materially affected by the initial supply-side shocks. In effect, consumers become less selective and are more likely to enter into less adequate transactions.

This dynamic reduces competitive pressure on firms, enhancing their pricing power.²⁰

The ability of supply-side shocks to generalize into broad-based inflation expectations, characterized by a perception of uniformly higher costs and prices, stems from how these expectations are formed. As explored in the diagnostic expectations literature (Bordalo et al., 2018, 2019, 2012, 2021), individuals tend to infer broader economic trends from specific, salient incidents, and often overweight recent events when predicting future outcomes. Consistent with this framework, Link et al. (2024) shows that consumers particularly attentive and informed about realized inflation rates have inflation expectations that deviate more significantly upward from professional forecasts compared to less attentive individuals. This finding suggests that consumers rely on their own—potentially misspecified—models when processing inflation-relevant information (see also Andrade et al., 2016; Andre et al., 2022; Laudenbach et al., 2024).

In the case of the experience channel, salient events include extreme price increases due to supply disruptions (De Bruin et al., 2011) and spikes in the cost of everyday goods such as food or gasoline (Cavallo et al., 2017; D’Acunto et al., 2021; Dietrich, 2024). These salient price increases lead consumers to place significant weight on them when forming their expectations about *overall* price trends. In the case of the news channel, salient events include reports about supply chain disruptions and their effects on costs and prices, especially when the media emphasizes potential economy-wide implications.²¹

²⁰In our model, we show that this effect can be amplified by fairness concerns in consumer behavior. Empirical evidence suggests that consumers tend to view price increases driven by rising costs as more acceptable than those driven by demand shocks (see Eyster et al., 2021 for a detailed discussion). The overestimation of a supply-side shock as a common shock driven by elevated generalized inflation expectations causes consumers to perceive firms’ prices as more fair. This perception reduces their price elasticity of demand, allowing firms—particularly those less directly affected by the initial supply-side shock—to charge higher markups and prices without significantly affecting demand.

²¹Since reports of supply-side constraints are often more salient and newsworthy, while their resolution receives little attention, this asymmetry can contribute to the persistence of elevated inflation expectations. Supporting this notion, Ascari et al. (2023) finds that increases in inflation expectations have a stronger

Besides diagnostic expectations, rational inattention (Sims, 2003) and sparsity (Gabaix, 2014) can also lead to generalized inflation expectations. Due to cognitive limitations, individuals face a trade-off between the benefits of acquiring additional information and the costs (time, effort, or cognitive resources) of processing it. Individuals thus tend to focus on the most relevant information while ignoring less critical details. In the context of inflation, individuals thus typically base their expectations on easily observable price signals (D’Acunto and Weber, 2024), such as rising prices of frequently purchased goods or news about increases in headline inflation, while selectively ignoring complex or technical information, such as disaggregated inflation data.²² If these easily observable signals indicate higher inflation, individuals may generalize this perception to the broader economy. If a supply shock elevates generalized inflation expectations, it is likely perceived as widespread—a common cost shock affecting many firms.²³

7 Conclusion

The post-pandemic era witnessed supply-side shocks that, combined with a swift economic recovery, resulted in a dramatic rise in inflation rates, levels which had not been observed in many decades. In this paper, we document the complex interactions between supply chain pressures, firm pricing power, and household inflation expectations that contributed to the surge, generalization, and persistence of post-pandemic inflation in the euro area.

impact than shocks that lower them, and Blanco et al. (2022) finds that inflation surges elevate long-term inflation expectations, which remain persistent throughout the disinflation process.

²²Relatedly, the theory proposed by Mei and Wu (2024) suggests that longer causal chains exert diminishing influence on beliefs, resulting in an overreaction of inflation expectations to cost-push news shocks.

²³Acharya et al. (2023) demonstrates that in a regime-switching model with parameter uncertainty, a *negative duration dependence* can take hold: if the economy remains in a regime for an extended period, even fully rational agents may begin to assign via learning a higher likelihood to the possibility of being in the regime with persistence, potentially indefinitely.

We find that supply chain disruptions not only contributed to localized inflation in sectors directly affected by the cost shock—such as manufacturing—through a cost-push mechanism, but also led to an increase in household inflation expectations. These elevated expectations appear to have facilitated a transmission of initially localized shocks into broad-based consumer price inflation, which began to emerge in the second half of 2021; that is, higher inflation even in sectors not initially impacted by supply-side disruptions, such as services. Overall, our findings suggest that supply-side inflationary impulses can generalize and intensify through household inflation expectations, lower consumer price sensitivity, and the resulting increase in firms’ pricing power.

From a policy perspective, three main implications emerge. First, “see through the shock” policy approaches may need to take into account the possibility of persistent and intertwined inflationary pressures. Policymakers may need to be prepared to act decisively to adjust the monetary policy stance if inflation expectations show the first signs of becoming unanchored. Second, elevated consumer inflation expectations can enhance firms’ pricing power, even for those not directly affected by the initial shock, which can be considered as an empirically tangible version of “excuseflation.” This implication provides support for measures that promote competition, thereby curbing the inflationary tendencies of dominant market players. Third, transparent communication by policymakers regarding the nature—such as the specific magnitude and duration—of relatively opaque cost shocks, along with a clear commitment to price stability, can help prevent a self-fulfilling prophecy in which unanchored inflation expectations translate into actual inflation.

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Online Appendix

OA.1 Detailed data description

Our analysis is based on various data sets for the euro area from 2019:Q1 to 2022:Q4. We use data about (i) firms’ production constraints and price expectations, all at the *industry-country-time level*; (ii) household inflation expectations at the *country-time level* and *household-time level*; (iii) CPI growth at the *product-country-time level*; and, (iv) *firm-time level* financials.

Joint Harmonised EU Programme of Business and Consumer Surveys. We obtain information about firms’ production constraints and household inflation expectations from the Joint Harmonised EU Programme of Business and Consumer Surveys (BCS) conducted by the European Commission’s Directorate-General for Economic and Financial Affairs (DG ECFIN). These surveys (harmonized across countries) are administered to a total of 37,990 corporations from manufacturing, services, retail trade, and construction industries and 31,810 households across the 27 EU member countries, on a monthly and quarterly basis.

Manufacturing firms are asked about firm-specific factors, such as production capacity, competitive position, price expectations, and factors constraining production. Consumers are questioned on both objective variables (e.g., inflation and the country’s general economic situation) and subjective assessments (e.g., major purchases and savings).

From the BCS firm survey, we use responses to the following two questions. First, we employ responses to the quarterly Question 8, which asks firms: “*What main factors are currently limiting your production?*” Firms can respond with (only) one of the following factors: (i) none, (ii) insufficient demand, (iii) shortage of labour force, (iv) shortage of material and/or equipment, (v) financial constraints, or (vi) other factors. The BCS then reports, at the industry-country-time level, the share of firms that respond that their production is constrained by the respective factor.

Second, we obtain inflation expectations at the country-time level from Question 6 that asks households: “*By comparison with the past 12 months, how do you expect that consumer prices will develop in the next 12 months?*” Respondents can reply: (i) increase more rapidly,

(ii) increase at the same rate, (iii) increase at a slower rate, (iv) stay about the same, or (v) fall. Following D’Acunto et al. (2022), we use the share of households expecting prices to increase more rapidly to measure high inflation expectations.

ECB Consumer Expectations Survey. Furthermore, we use newly available anonymized household-time level inflation expectations microdata from the ECB Consumer Expectations Survey (CES) launched in 2020. Its sample covers six key euro area countries: Belgium, France, Germany, Italy, Spain, and the Netherlands, and it is representative of the euro area population (Bańkowska et al., 2021). The CES comprises monthly *core*, *background*, and *recruitment* questionnaires, along with a quarterly questionnaire. The core questionnaire addresses households’ expectations in areas such as macroeconomic conditions, housing markets, and their financial situation. The quarterly and background modules contain additional questions on household expenditures, savings, employment, borrowing, risk attitudes, financial knowledge, and income. A total of 18,492 distinct respondents participated in the 12 CES waves and households appear repeatedly in the survey, allowing us to compare responses of the same household over time.

To measure inflation expectations at the country-time and household-time level consistently across the two surveys (BCS and CES), we use the responses to CES’ Question C1110 that asks households: “*Looking ahead to 12 months from now, what do you think will happen to prices in general?*” Similar to the BCS, households can answer: (i) prices will increase a lot, (ii) prices will decrease a lot, (iii) prices will increase a little, (iv) prices will decrease a little, or (v) prices will be exactly the same (that is 0% change). We again classify a household as having high inflation expectations if the household responds that prices will increase a lot.

Additionally, the CES provides insight into households’ long-term inflation expectations. Specifically, Question C1210 asks: “*Please think further ahead to <survey month year+2>. What do you think will happen to prices in general in the country you currently live in over the 12-month period between <survey month year+2 and survey month year+3>?*” Again, we classify a household as having high inflation expectations if it indicates that prices will increase a lot.

Other data sources. We also use monthly data on consumer prices from Eurostat, which provides information for various producer and consumer price indices for all European coun-

tries. In this granular data, we observe prices at the product-country-time level. Products are grouped in COICOP categories.²⁴ From Eurostat, we also obtain an industry-country level input-output table as well as data about industry-country-time level energy input use and energy prices at the country-time level.

Finally, we use firm-time level financial data from Compustat Global to estimate firm markups following De Loecker et al. (2020).

Data transformations. We transform variables from the industry-country-quarter level to the product-country-quarter level in two steps. First, we use a EU inter-country input-output table (Eurostat Figaro) to capture industries from different countries contributing to the sales of a specific product in a specific country.²⁵ For example, cars sold in Germany are produced not only in Germany but also in Italy, Spain, etc.

Second, we use the inverse of the COICOP-CPA matrix from Cai and Vandyck (2020) to transform the production constraints from the industry-country-time level to the product-country-time level by calculating a weighted constraints measure of all CPA categories that are related to a COICOP category (two digits). Consider, for example, the product category “Food and non-alcoholic beverages” (COICOP 01). This product’s COICOP is a weighted average of, among others, the following CPA categories: (i) products of agriculture, hunting, and related services, (ii) fish and fishing products, and (iii) food products.

Similarly, we transform variables from the industry-country-time level to the country-time level using the share of consumption that each industry contributes to the final household consumption (using the COICOP-CPA matrix from Cai and Vandyck, 2020) as weights.

²⁴The Classification of Individual Consumption According to Purpose (COICOP) is the international reference classification of household expenditure. It provides homogeneous categories of goods and services.

²⁵The Figaro data is available at <https://ec.europa.eu/eurostat/web/esa-supply-use-input-tables>.

OA.2 Additional Figures



Figure OA.1: Inflation in euro area. This figure shows the CPI growth in the euro area at a monthly frequency from January 2016 to April 2023.



Figure OA.2: Chinese lockdown stringency index. This figure shows the time-series evolution of the aggregate stringency index of the top-5 exporting provinces in China.

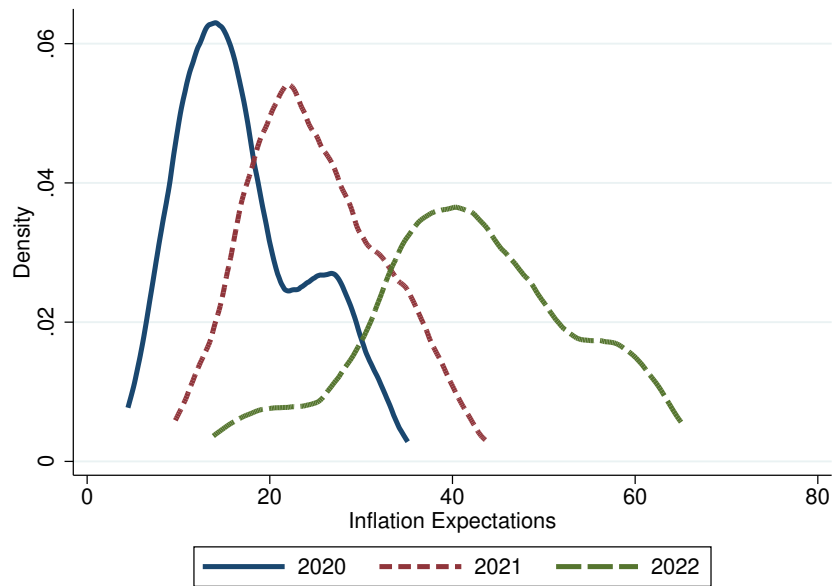


Figure OA.3: Distribution of inflation expectations over time. The figure shows three snapshots of the distribution of one-year ahead household inflation expectations.

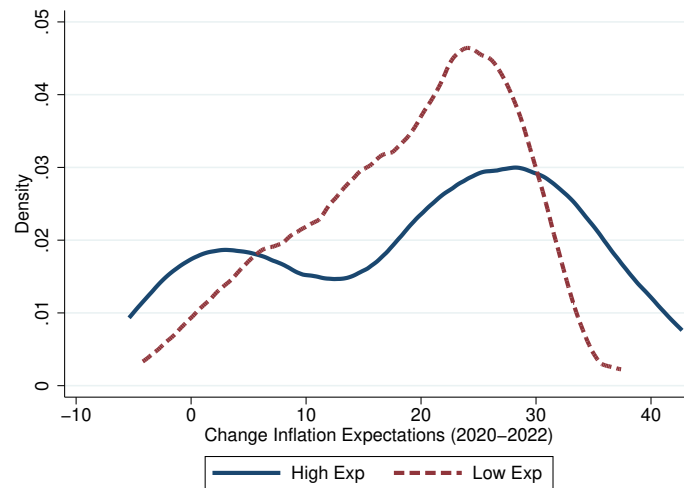


Figure OA.4: Growth in the share of households with high inflation expectations (growth between 2020 and 2022). The figure plots the growth in the share of households who believe prices will increase more rapidly, separately for high and low inflation expectation countries.

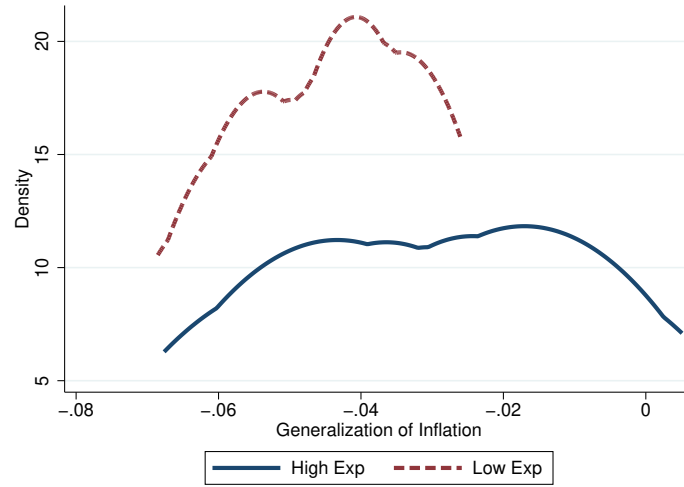


Figure OA.5: Difference service – manufacturing inflation in high vs. low inflation expectation countries (growth between 2020 and 2022). The figure plots the density (across countries, with countries bracketed by high vs. low inflation expectations) of the difference in service vs. manufacturing inflation from 2020 to 2022.

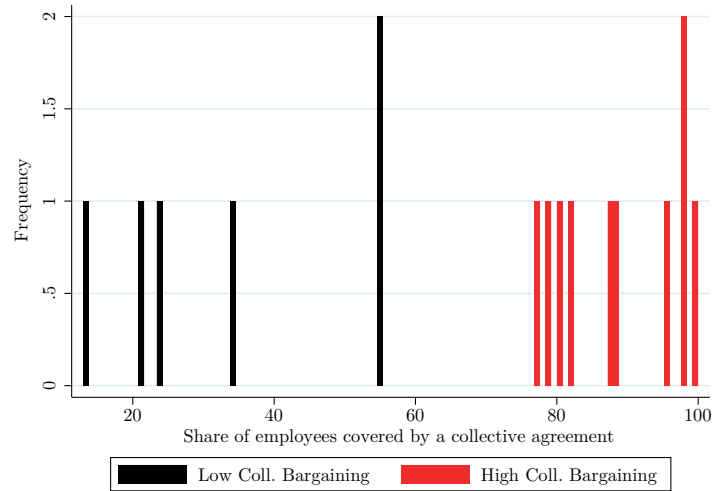


Figure OA.6: Share of employees covered by a collective agreement. This figure shows the distribution of the adjusted collective bargaining coverage rate from the OECD/AIAS ICTWSS database for our sample countries. This coverage rate is defined as the number of employees covered by a collective agreement in force as a proportion of the number of eligible employees equipped (i.e., the total number of employees minus the number of employees legally excluded from the right to bargain).

OA.3 Additional Tables

Dependent variable: $\hat{\pi}_{ht}^e$	(1)	(2)	(3)	(4)
Awareness _h × Google _{ct} × Material _{ct}	1.341*** (0.225)	1.308*** (0.220)	2.227*** (0.295)	1.493*** (0.222)
Material _{ct} × Awareness _h	0.140 (0.119)	0.514*** (0.120)	−0.497*** (0.173)	0.368*** (0.121)
Awareness _h × Google _{ct}	−0.293*** (0.047)	−0.163*** (0.042)	−0.089* (0.054)	−0.147*** (0.044)
Awareness _h × Food Inflation _{ct}	0.542*** (0.115)		1.963*** (0.673)	
Awareness _h × Food Inflation _{ct} × Google _{ct}			−2.096* (1.191)	
Awareness _h × Energy Inflation _{ct}	0.186*** (0.022)		0.262** (0.133)	
Awareness _h × Energy Inflation _{ct} × Google _{ct}			−0.085 (0.228)	
Awareness _h × Core Inflation _{ct}	2.560*** (0.365)		8.960*** (1.752)	
Awareness _h × Core Inflation _{ct} × Google _{ct}			−11.845*** (3.156)	
Perceived (realized) inflation _{ht}		0.900*** (0.035)		1.555*** (0.151)
Awareness _h × Perceived (realized) inflation _{ht}		−0.126** (0.052)		0.516** (0.250)
Perceived (realized) inflation _{ht} × Google _{ct}				−1.179*** (0.262)
Awareness _h × Perceived (realized) inflation _{ht} × Google _{ct}				−0.957** (0.415)
Observations	103,088	103,088	103,088	103,088
R-squared	0.549	0.556	0.549	0.556
Other constraints	✓		✓	✓
Country-time FE		✓		
Household FE	✓	✓	✓	✓

Table OA.1: Supply chain constraint pass-through to household inflation expectations: Interactions with household characteristics. This table presents estimation results from an adjusted version of Specification (4). The subscript notation is defined as follows: h is a household, c is a country, and t is a quarter. The dependent variable is a household-time level dummy equal to one if household h believes prices will increase a lot over the next 12 month. *Material*, *Labor*, *Financial*, *Equipment*, and *Other* measure the share of firms that indicate that their production is constrained by the respective constraint. All constraints are transformed from the industry-country-time level to the country-time level using the share of consumption that each industry contributes to the final household consumption. *Awareness* is a dummy equal to one for households with an above median within household correlation between realized inflation over the last 12 months and the household’s inflation estimate for the last 12 months. *Google* is a country-time level variable measuring the intensity of Google searches for “delays in shipping” (in the respective country’s language). Non-reported controls include the other perceived constraints to production (*Labor*, *Financial*, *Equipment*, and *Other*) in Columns (1), (3), and (4). *Food Inflation*, *Energy Inflation*, and *Core Inflation* are the country-time level CPI indices for food, energy, and core, respectively. *Perceived (realized) Inflation* is household h ’s perception about the inflation over the last 12 months. Standard errors are clustered at the country-demographics level and are reported in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

OA.4 Theoretical framework

To examine how consumers' generalized inflation expectations influence firms' pricing behavior, we employ a duopolistic search market equilibrium model, drawing on the search model from [Benabou and Gertner \(1993\)](#) and the fairness concern framework from [Eyster et al. \(2021\)](#).

OA.4.1 Setup

There are two firms with index $i \in \{1, 2\}$, which have constant marginal costs C_i :

$$C_i = e^{\bar{c} + \theta + \gamma_i}, \quad (\text{OA.1})$$

where \bar{c} is the lower bound of the marginal costs, $\theta \sim \mathcal{N}(0, \psi_\theta)$ is a common cost shock affecting both firms equally, while $\gamma_i \sim \mathcal{N}(Z_i, \psi_\gamma)$ are independent firm-specific shocks, with Z_i characterizing the extent of a firm-specific supply-side shock. The firms cannot price-discriminate, implying that each unit of their good sells at the same price, P_i .

Influence of generalized inflation expectations. Customers cannot directly observe firms' marginal production costs. Instead, they infer these costs based on the observed price and their understanding of the broader economic environment, which is shaped by their perceptions of supply-side cost shocks and the resulting inflation expectations.

To formalize this belief formation process (as outlined in Section 3) and examine its implications for firms' pricing strategies in response to supply-side shocks during the pandemic, we introduce a biased belief function $C_i^B(P_i)$. This function maps the price that a monopoly with marginal costs C_i would set to consumers' biased perception of these costs as follows:

$$C_i^B(P_i) = e^{\bar{c} + \hat{\theta} + \hat{\gamma}_i}, \quad (\text{OA.2})$$

where $\hat{\theta} \sim \mathcal{N}(b_Z, \psi_\theta)$, and $\hat{\gamma}_i \sim \mathcal{N}(\max(0, Z_i - b_Z), \psi_\gamma)$ with $b_Z > 0$. This belief function captures that elevated generalized inflation expectations are associated with a tendency to misinterpret a supply-side shock affecting only certain firms as a broader shock impacting a wider range of firms. Consequently, the supply-side cost shock is at least partially attributed to a common shock, rather than being recognized as firm-specific.

OA.4.2 Effect of generalized inflation expectations on firm pricing through search

First, we explore the effect of generalized inflation expectations on firm pricing through its impact on consumers' perceived value of search. There is a continuum of identical consumers, with measure normalized to one, and their demand function in absence of search is given by:

$$Y_i^d(P_i) = P_i^{-\eta}. \quad (\text{OA.3})$$

Hence, the profit function of a monopolist with cost C_i is $(P_i - C_i)Y_i^d(P_i)$, and its maximum value is given by

$$P_i^m(C_i) = \frac{\eta}{\eta - 1} \cdot C_i. \quad (\text{OA.4})$$

To study the effect of search on firm pricing, we assume that, initially, half the consumers observe firm 1's price, and the other half observe firm 2's price, at no cost. Given the observed price, each consumer decides whether to purchase at that price or search further to learn the price from the other firm. Searching entails a cost $\sigma > 0$, but it allows consumers to buy at the lower of the two prices.

Without loss of generality, let us consider consumers who first observe the price P_1 . Upon observing P_1 , they infer firm 1's underlying marginal cost structure. Using this information, they then form a posterior belief about the distribution of firm 2's price, denoted $G(P_2 | P_1)$ with density $g(P_2 | P_1)$. Based on these beliefs, the consumers then decide whether it is worthwhile to search and discover P_2 . Specifically, upon observing P_1 , consumers map this price to the biased marginal cost C_1^B and form a biased Bayesian posterior for C_2^B . This posterior is subsequently mapped to the monopoly price P_2^m that a firm with costs C_2^B would charge. For convenience, we define $c \equiv \log C$ and $p_i^m(c) \equiv \log(P_i^m(C))$.

The conditional distribution of c_2^B , given $c_1^B = c$, is normal with mean,

$$E[c_2^B | c] = \rho c + (1 - \rho) (\bar{c} + \max(b_Z, Z_2)),$$

where

$$\rho = \frac{\psi_\theta}{\psi_\theta + \psi_\gamma}, \quad (\text{OA.5})$$

and variance:

$$\text{Var}(c_2^B | c) = (1 - \rho^2)(\psi_\theta + \psi_\gamma).$$

The unconditional distribution of p_2^m is normal, with mean

$$\bar{p} \equiv \bar{c} + (\bar{c} + \max(b_Z, Z_2)) + \log \left(\frac{\eta}{\eta - 1} \right). \quad (\text{OA.6})$$

Moreover, the conditional distribution of $p_2^m(c_2^B)$, given $c_1^B = c$, is normal with mean,

$$\mu(p) \equiv \rho p + (1 - \rho)\bar{p},$$

and variance:

$$s^2 \equiv (1 - \rho^2)(\psi_\theta + \psi_\gamma).$$

The expected gain from search. Let $S(p) \equiv \int_p^\infty Y_i^d(r) dr$ be the surplus that consumers derive from buying at price p ; thus:

$$S(p) = \frac{1}{\eta - 1} e^{(1-\eta)p}. \quad (\text{OA.7})$$

Therefore, after observing p_1 , consumers' expected gain from search is given by:

$$\begin{aligned} W(p_1) &= \int_{-\infty}^{p_1} [S(p_2) - S(p_1)] g(p_2 | p_1) dp_2 \\ &= \frac{1}{\eta - 1} \int_{-\infty}^{p_1} \frac{1}{\sqrt{2\pi}s} \{ \exp[(1 - \eta)p_2] - \exp[(1 - \eta)p_1] \} \exp \left[-\frac{(p_2 - \mu(p_1))^2}{2s^2} \right] dp_2. \end{aligned}$$

If $W(p_1) > \sigma$, a consumer chooses to search; otherwise, the consumer buys immediately at price p_1 . Moreover, define consumers' reservation price p_1^* as the smallest solution to:

$$W(p_1^*) = \sigma.$$

Accordingly, consumers are thus indifferent between searching and purchasing from firm 1 when it charges p_1^* . Let c_1^* denote the cost level such that $p_1^m(c_1^*) = p_1^*$. Consequently, if firm 1's cost level is $c_1 > c_1^*$ and it charges its monopoly price, it will induce search. Rather than incur the first-order loss in customers (who may search and potentially find a lower price),

the firm opts to charge p_1^* , avoiding customer loss and experiencing only a second-order effect on profits per customer.

Rewriting the consumers' expected gain from search, $W(p_1)$, in terms of the distribution Φ of a standard normal gives:

$$\begin{aligned} W(p_1) = & \frac{1}{\eta - 1} \exp \left[-\frac{(\eta - 1)}{2} [2\bar{p} + 2\rho(p_1 - \bar{p}) - s^2(\eta - 1)] \right] \\ & \cdot \Phi \left[\frac{(1 - \rho)(p_1 - \bar{p}) + s^2(\eta - 1)}{s} \right] \\ & - \frac{1}{\eta - 1} \exp [-(\eta - 1)p_1] \cdot \Phi \left[\frac{(1 - \rho)(p_1 - \bar{p})}{s} \right]. \end{aligned} \quad (\text{OA.8})$$

Generalized inflation expectations and the perceived search value. Taking the derivative of $W(p_1)$ with respect to the extent of common shock bias b_Z yields:

$$\frac{\partial W(p_1)}{\partial b_Z} = \begin{cases} -(1 - \rho) \exp \left(-\frac{(\eta - 1)}{2} [2\bar{p} + 2\rho(p_1 - \bar{p}) - s^2(\eta - 1)] \right) \\ \quad \cdot \Phi \left(\frac{(1 - \rho)(p_1 - \bar{p}) + s^2(\eta - 1)}{s} \right) < 0 & \text{if } b_Z > Z_2, \\ 0 & \text{if } b_Z \leq Z_2. \end{cases}$$

Hence, the effect of an increase in b_Z on the search value of consumers depends on the sector and its exposure to supply-side shocks.

For less affected sectors—where $b_Z > Z_2$ (e.g., service sectors)—an increase in the mean of the conditional distribution of $p_2^m(c_2^B)$ conditional on $p_1 = p$, driven by a higher b_Z (i.e., attributing the supply-side cost shock to a common shock across both firms), reduces the perceived option value of search. This effect arises because consumers in these sectors are effectively overestimating the average price level in the market. This dynamic reduces competitive pressure on firm 1, raising its market power. As a result, the reservation price p_1^* shifts upward, allowing firm 1 to charge higher prices without inducing consumers to search for alternatives. Correspondingly, the threshold cost level c_1^* increases, extending the range of cost levels over which firm 1 can charge monopoly markups.

In contrast, in sectors more directly impacted by the supply-side shock—where $b_Z \leq Z_2$ (e.g., manufacturing)—this effect does not arise. The greater actual commonality in costs

across firms means that consumers' attribution of elevated costs to a shared shock is accurate. As a result, their posterior beliefs about firm 2's prices reflect the true cost structure, leaving the reservation price p_1^* unchanged. Consequently, there is no distortion in market power, and firm 1's pricing behavior remains unaffected by the attribution of the shock.

While we study a single product market, our findings are also applicable to multiple product markets where the consumption of different products is interconnected through a positive cross-elasticity of demand. A lower perceived option value of search the cross-price elasticity of demand. This reduction, in turn, causes an upward shift in the demand curve for individual firms.

OA.4.3 Effect of generalized inflation expectations on firm pricing through fairness concerns

Next, we explore how the overestimation of the magnitude of the common shock (i.e., bias $b_Z > 0$) impacts firm pricing through consumers' fairness concerns. To study this effect, we consider a case without search, and where customers assess transactional fairness by evaluating the perceived markup charged by firms.

Consumers' fairness concerns. There is microevidence supporting the idea that consumers care about fairness (see [Eyster et al., 2021](#) for a detailed discussion). Customers typically perceive price hikes driven by increased demand as unfair, whereas those resulting from rising costs are viewed more acceptably (e.g., [Kahneman et al., 1986](#); [Frey and Pommerehne, 1993](#); [Gielissen et al., 2008](#); and [Shiller et al., 1991](#)). Perceived unfair pricing can reduce customers' willingness to pay (e.g., [Piron and Fernandez, 1995](#); [Rotemberg, 2008](#); and [Urbany et al., 1989](#)). Firms also recognize that customers respond negatively to markups perceived as unfair (e.g., [Blinder et al., 1998](#) and [Eyster et al., 2021](#)).

To capture consumers' fairness concerns, we assume that the perceived markup (over perceived costs) determines a transaction's perceived fairness, represented by a twice differentiable fairness function $F(M^B)$, which is positive, strictly decreasing, and weakly concave over $[0, M^h]$, where $F(M^h) = 0$ and $M^h > \eta/(\eta - 1)$. The decreasing nature of F reflects customers' aversion to higher markups, while its weak concavity implies that increases in perceived markup lead to a utility loss at least as large as the utility gain from an equal-sized decrease in the perceived markup.

Generalized inflation expectations are associated with consumers' overestimation of the magnitude of the common shock, which influences their fairness assessments. Specifically, consumers form biased beliefs about firms' marginal costs and infer the firms' markup accordingly. Given these biased perceptions, consumers infer that the markup is as follows:

$$M^B(P_i) = \frac{P_i}{E[C^B(P_i)]}. \quad (\text{OA.9})$$

A customer who purchases quantity Y_i of the good at price P_i thus experiences the following fairness-adjusted consumption:

$$A = F(M^B(P_i)) \cdot Y_i.$$

Customers also face a budget constraint:

$$P_i \cdot Y_i + B = I,$$

where $I > 0$ represents initial wealth, and B denotes remaining money balances. Fairness-adjusted consumption and money balances are incorporated into a quasilinear utility function:

$$\frac{\eta}{\eta - 1} \cdot A^{(\eta-1)/\eta} + B,$$

where the parameter $\eta > 1$ governs the concavity of the utility function. Given the fairness factor F and price P_i , customers choose their purchases Y_i and money balances B to maximize utility, subject to the budget constraint:

$$\frac{\eta}{\eta - 1} (F \cdot Y_i)^{(\eta-1)/\eta} + I - P_i \cdot Y_i.$$

The maximum of the customers' utility function is determined by the following first-order condition (FOC):

$$F^{(\eta-1)/\eta} \cdot Y_i^{-1/\eta} = P_i,$$

which yields the following demand function:

$$Y_i^d(P_i) = P_i^{-\eta} \cdot F(M^B(P_i))^{\eta-1}. \quad (\text{OA.10})$$

The price affects demand through two channels: the typical substitution effect, represented

by $P_i^{-\eta}$, and the fairness channel, captured by $F(M^B(P_i))^{\eta-1}$. The fairness channel arises because the price influences the perceived markup, and thus the perceived fairness of the transaction; this, in turn, impacts the marginal utility of consumption and, consequently, demand.

Firm pricing under fairness concerns. When firms set prices under fairness concerns, they need to account for how the perceived fairness of their markups influences customers' willingness to pay. Consequently, firms must balance the direct impact of the price on profit margins with the indirect effect of perceived fairness on the demand elasticity.

Specifically, in the absence of search, the two firms set price P_i and output Y_i to maximize profits $(P_i - C_i) \cdot Y_i^d(P_i)$, subject to customers' demand for their good. The resulting FOC is:

$$Y_i^d(P_i) + (P_i - C_i) \frac{dY_i^d}{dP_i} = 0. \quad (\text{OA.11})$$

We introduce the price elasticity of demand, normalized to be positive:

$$E_i = -\frac{d \ln(Y_i^d)}{d \ln(P_i)} = -\frac{P_i}{Y_i^d} \cdot \frac{dY_i^d}{dP_i},$$

which implies together with the FOC from Eq. (OA.11) for the monopoly price that

$$P_i^m(C_i) = \frac{E_i}{E_i - 1} \cdot C_i. \quad (\text{OA.12})$$

From Eq. (OA.10), we find the elasticity E :

$$E_i = \eta + (\eta - 1) \cdot \phi(M^B) > \eta, \quad (\text{OA.13})$$

where

$$\phi(M^B) = -\frac{d \ln(F)}{d \ln(M^B)}$$

is the elasticity of the fairness function with respect to the perceived markup. The properties of the fairness function F imply the following lemma (for the proof, please refer to Online Appendix A of [Eyster et al., 2021](#)).

Lemma 1. *The elasticity of the fairness function $\phi(M^B)$ is strictly positive and strictly increasing on $(0, M^h)$, with $\lim_{M^B \rightarrow 0} \phi(M^B) = 0$ and $\lim_{M^B \rightarrow M^h} \phi(M^B) = +\infty$. As an*

implication, the superelasticity of the fairness function

$$\kappa = \frac{d \ln(\phi)}{d \ln(M^B)}$$

is strictly positive on $(0, M^h)$.

The second term in Eq. (OA.13), $(\eta - 1) \cdot \phi$, represents the fairness channel, which implies that higher perceived marginal costs and a lower price reduce the perceived markup, thereby increasing the perceived fairness and lowering the price elasticity of demand.

From Eq. (OA.12) and Eq. (OA.13) it follows that the firms' monopoly price is given by

$$P_i^m = \left(\frac{\eta + (\eta - 1)\phi}{(\eta - 1)(1 + \phi)} \right) \cdot C_i. \quad (\text{OA.14})$$

Generalized inflation expectations and price elasticity of demand. Next, we investigate the effect of consumers' overestimation of the common cost shock, b_Z , on optimal firm pricing. To this end, we calculate the derivative of P_i^m with respect to b_Z using the chain rule, as ϕ depends on the perceived markup M^B , which in turn is influenced by b_Z :

$$\frac{dP_i^m}{db_Z} = \frac{dP_i^m}{d\phi} \cdot \frac{d\phi}{db_Z}, \quad (\text{OA.15})$$

where the derivative of P_i^m with respect to ϕ is given by:

$$\frac{dP_i^m}{d\phi} = -\frac{C_i}{(\eta - 1)(1 + \phi)^2} < 0. \quad (\text{OA.16})$$

Plugging Eq. (OA.16) into Eq. (OA.15) yields:

$$\frac{dP_i^m}{db_Z} = -\frac{C_i}{(\eta - 1)(1 + \phi)^2} \cdot \frac{d\phi}{db_Z}. \quad (\text{OA.17})$$

Hence, to determine the sign of dP_i^m/db_Z , we next need to establish the sign of $d\phi/db_Z$. Since ϕ depends on b_Z via the perceived markup given in Eq. (OA.9), we have:

$$\frac{d\phi}{db_Z} = \frac{d\phi}{dM^B(P_i)} \cdot \frac{dM^B(P_i)}{db_Z}, \quad (\text{OA.18})$$

for which we know that $d\phi/dM^B(P_i) > 0$ from Lemma 1. To determine $dM^B(P_i)/db_Z$, we first substitute the actual and perceived marginal costs into Eq. (OA.9), which, after simplification, yields:

$$M^B(P_i) = \left(\frac{\eta + (\eta - 1)\phi}{(\eta - 1)(1 + \phi)} \right) \cdot e^{-b_Z}. \quad (\text{OA.19})$$

The derivative of $M^B(P_i)$ with respect to b_Z is given by:

$$\frac{dM^B(P_i)}{db_Z} = \begin{cases} = - \left(\frac{1}{(\eta-1)(1+\phi)^2} \cdot \frac{d\phi}{db_Z} + \frac{\eta+(\eta-1)\phi}{(\eta-1)(1+\phi)} \right) \cdot e^{-b_Z} & \text{if } b_Z > Z_1, \\ 0 & \text{if } b_Z \leq Z_1. \end{cases} \quad (\text{OA.20})$$

Substituting Eq. (OA.18) into Eq. (OA.20) and solving for $dM^B(P_i)/db_Z$ yields

$$\frac{dM^B(P_i)}{db_Z} = \begin{cases} = - \frac{\left(\frac{\eta+(\eta-1)\phi}{(\eta-1)(1+\phi)} \right) \cdot e^{-b_Z}}{1 + \frac{e^{-b_Z}}{(\eta-1)(1+\phi)^2} \cdot \frac{d\phi}{dM^B(P_i)}} < 0 & \text{if } b_Z > Z_1, \\ 0 & \text{if } b_Z \leq Z_1. \end{cases} \quad (\text{OA.21})$$

Eq. (OA.21) together with Eq. (OA.18) imply that $d\phi/db_Z < 0$ if $b_Z > Z_1$, which in turn implies that $dE/db_Z < 0$ (see Eq. OA.13) and that $dP_i^m/db_Z > 0$ (see Eq. OA.17). Therefore, the overestimation of the common cost shock magnitude, b_Z , reduces the price elasticity of demand E whenever $b_Z > Z_1$ due to consumers' fairness concerns, prompting firms to set higher prices.

Finally, we determine the derivative of the actual markup with respect to b_Z . Plugging the price P_i^m from Eq. (OA.14) into the actual markup (P_i/C_i) yields:

$$M_i = \frac{P_i}{C_i} = \left(\frac{\eta + (\eta - 1)\phi}{(\eta - 1)(1 + \phi)} \right); \quad (\text{OA.22})$$

thus, the derivative of M_i with respect to b_Z is given by:

$$\frac{dM_i}{db_Z} = \frac{dM_i}{d\phi} \cdot \frac{d\phi}{db_Z},$$

since ϕ again depends on the perceived markup, which depends on b_Z . Taking the derivative

of M_i with respect to ϕ yields:

$$\frac{dM_i}{d\phi} = -\frac{1}{(\eta-1)(1+\phi)^2} < 0. \quad (\text{OA.23})$$

Hence, the derivative of M_i with respect to b_Z is:

$$\frac{dM_i}{db_Z} = \begin{cases} = -\frac{1}{(\eta-1)(1+\phi)^2} \cdot \frac{d\phi}{db_Z} > 0 & \text{if } b_Z > Z_1, \\ 0 & \text{if } b_Z \leq Z_1. \end{cases} \quad (\text{OA.24})$$

Therefore, the overestimation of the size of the common cost shock, b_Z , also increases the actual markup charged by firms in the absence of search if $b_Z > Z_1$.

In summary, when consumers have elevated generalized inflation expectations, they attribute higher prices to broader market-wide cost increases, which reduces their perception of unfairness in pricing. This shift lowers the price elasticity of demand, as consumers become less responsive to price hikes. Firms capitalize on this reduced elasticity by increasing their markups and prices. These effects are again more pronounced in sectors less affected by supply-side shocks.