

# Imperfect Information, Composition of Demand Shocks, and the Flattening of the Phillips Curve\*

Tatsushi Okuda<sup>†</sup>

Bank of Japan

Tomohiro Tsuruga<sup>‡</sup>

International Monetary Fund

Francesco Zanetti<sup>§</sup>

University of Oxford and CEPR

April 2026

## Abstract

We study why inflation responds differently to economic activity over time. Using survey data covering the universe of Japanese firms, we show that firms are unable to perfectly distinguish aggregate from sector-specific demand changes, leading to positively correlated expectations about these two components. We develop a model with imperfect information that reproduces this pattern and predicts that higher relative volatility of sector-specific demand reduces the sensitivity of inflation to changes in aggregate demand, thus flattening the Phillips curve. Testing this prediction with Japanese data from 1976 to 2022, we find that increases in the volatility of sectoral demand shocks explain significant changes in the Phillips curve slope over the sample period. Our results provide a novel explanation for the flattening of the Phillips curve: the composition of shocks – not just their magnitude – critically affects the sensitivity of inflation to aggregate demand.

JEL Classification: E31, D82, C72.

Keywords: Imperfect information, Shock heterogeneity, Inflation dynamics, Survey of expectations of Japanese firms.

---

\*This paper subsumes previous work circulated under the title: “Imperfect Information, Shock Heterogeneity, and Inflation Dynamics.” We would like to thank Jesus Fernandez-Villaverde, Gaetano Gaballo, Laura Gati, Nobuhiro Kiyotaki, Jennifer La’O, Xiaowen Lei, Alistair Macaulay, Sushanta Mallick, Sophocles Mavroeidis, Taisuke Nakata, Shigenori Shiratsuka, Chris Sims, Wataru Tamura, Takayuki Tsuruga, Laura Veldkamp, Mirko Wiederholt, Xiaowen Wang, Yifan Zhang, and seminar participants at the University of Oxford, SWET 2018, 2018 JEA Autumn Meeting, WEAI 2019, Inflation: Drivers and Dynamics Conference 2019, Econometric Society European Winter Meeting 2020, Econometric Society North American Summer Meeting 2021, workshop on New Directions in Inflation Forecasting, Royal Economic Society 2022 Annual Conference, and the ECB-Cleveland Fed Conference 2022 for extremely valuable comments and suggestions. The views expressed in this paper are those of the authors and do not necessarily represent the views of the Bank of Japan, IMF, its Executive Board, or IMF management.

<sup>†</sup>Bank of Japan: [tatsushiokuda@gmail.com](mailto:tatsushiokuda@gmail.com).

<sup>‡</sup>International Monetary Fund: [TTsuruga@imf.org](mailto:TTsuruga@imf.org).

<sup>§</sup>University of Oxford, Department of Economics: [francesco.zanetti@economics.ox.ac.uk](mailto:francesco.zanetti@economics.ox.ac.uk).

# 1 Introduction

A large class of macroeconomic models builds on the premise that firms set prices to maximize profits by optimally responding to demand, and several studies show that shocks to demand are heterogeneous and reflect aggregate and sector-specific disturbances.<sup>1</sup> The classic study by [Ball and Mankiw \(1995\)](#) shows that the optimal price changes if the movement in demand originates from the aggregate shock, but it remains unchanged if the movement originates from the sector-specific shock. In reality, however, information is imperfect and firms cannot perfectly distinguish the source of changes in demand. Thus, firms optimally adjust prices based on expectations about whether the source of the demand change stems from aggregate or sector-specific disturbances.

Despite the centrality of expectations to price changes, empirical evidence on expectations about the distinct aggregate and sector-specific components of demand is scarce. Moreover, despite a tight link between the source of the shock and the firm’s optimal pricing decision often assumed in standard models with perfect information, there are no studies that connect imperfect information on the different components of demand to the sensitivity of inflation to economic activity.

Our analysis fills these gaps by providing novel empirical evidence on the formation of expectations about the different components of demand from unique sector-level survey data for the universe of Japanese firms, and developing a simple model of imperfect information that links those expectations to the sensitivity of inflation to economic activity. We show that imperfect information on the components of demand plays a critical role in explaining the observed positive co-movement in the expectations about the different components of demand and to account for the changes in the sensitivity of inflation to changes in economic activity in Japan over the past three decades.

Our analysis establishes four new results. First, using two distinct sector-level surveys covering the universe of Japanese firms across approximately 30 sectors, we document novel evidence of positive cross-sectional co-movement between firms’ expectations about aggregate demand and their expectations about sector-specific demand. This finding is important because it contradicts models based on perfect information, which predict that expectations formed by observing orthogonal aggregate and sector-specific demand shocks should

---

<sup>1</sup>Several studies, such as [Rafiq and Mallick \(2008\)](#), [di Giovanni et al. \(2014\)](#), [Xu et al. \(2025\)](#), and [Qiu et al. \(2026\)](#), show that demand fluctuations depend on aggregate and idiosyncratic components (across sectors or countries).

be independent without systematic co-movement.<sup>2</sup>

Second, we demonstrate that imperfect information on the *current* shocks to demand is critical to generating the observed positive co-movement in firms' expectations. Motivated by the empirical results, we extend the seminal island framework in [Lucas \(1972\)](#) with nominal price rigidities, assuming that firms cannot separately observe the different aggregate and sector-specific components that jointly move the observed demand and cannot adjust prices flexibly. We prove analytically that imperfect information generates a positive co-movement in expectations about the different components of demand that is consistent with the survey data.

Third, we use our model to study the sensitivity of inflation to changes in aggregate demand. Nominal price rigidities link inflation to the expectations of demand that in our model comprise the expectations on the different aggregate and sector-specific components. We show that the degree of sectoral heterogeneity in demand shocks – encapsulated by the ratio of the volatility of sector-specific demand shocks with respect to the volatility of aggregate demand shocks – is critical for the sensitivity of inflation to demand. Under perfect information, if the change in total sectoral demand originates from the aggregate component of demand, the price adjustment is large as a result of strategic complementarity in price-setting that leads all firms to adjust prices in response to the aggregate shock. If instead the change in total sectoral demand originates from the sector-specific component of demand, the price adjustment in the sector is contained since firms would either lose customers (if the price rises) or forego earnings for a lower markup (if the price falls), while firms in other sectors maintain the same price. Imperfect information prevents firms from accurately disentangling the different contributions of aggregate and sector-specific components to total sectoral demand. Therefore, firms optimally attribute part of a change in total sectoral demand to movements in the sector-specific component of demand and thus underreact to shocks compared to an environment with perfect information. A testable prediction of our theoretical framework is that the response of prices to aggregate demand is inversely related to the volatility of sector-specific shocks.

Fourth, we test the prediction from the model on the inverse relationship between the volatility of sector-specific shocks and the response of inflation to aggregate demand on

---

<sup>2</sup>Our framework explicitly incorporates aggregate and sector-specific shocks, assumed to be orthogonal, following [Mackowiak et al. \(2009a\)](#). This modeling choice is consistent with our empirical analysis, which relies on sectoral average expectations and sectoral demand rather than firm-level variables.

Japanese data. We estimate the volatility of the sector-specific component of demand relative to the volatility of the aggregate component of demand by using principal component analysis on sector-level data for Japanese firms across 29 sectors over the period 1976-2022. In line with the theory, we show that the increase in the ratio of the volatility in sector-specific shocks compared to the volatility in aggregate shocks played a significant role in the reduction of the sensitivity of inflation to aggregate demand. The same pattern is also confirmed for sectoral inflation. Moreover, taken together with the rise in volatility observed in the 2000s and 2010s, the results indicate that our framework can explain the flattening of the Phillips curve in Japan over the same period.<sup>3</sup>

Our findings have important implications for monetary policy and inflation forecasting. First, they suggest that the flattening of the Phillips curve observed across advanced economies may partly reflect structural changes in the composition of economic shocks rather than solely changes in expectations anchoring or labor market institutions. This distinction matters: if shock composition drives the flattening, then the Phillips curve slope is endogenous to the economic environment rather than a stable structural parameter. Second, our results imply that central banks should monitor not just the magnitude of economic fluctuations, but also their sectoral composition. Periods with high cross-sectoral volatility – such as during structural transformations, trade disruptions, or asymmetric technological shocks – will naturally exhibit dampened inflation responses to aggregate demand, complicating inflation forecasting and requiring more aggressive policy responses to achieve inflation targets. Third, our framework provides a lens for understanding why inflation forecasting has become more challenging: as economies experience more heterogeneous sectoral shocks (e.g., digital transformation affecting sectors unevenly, pandemic-related reallocation), the historical relationship between activity and inflation becomes less reliable.

Our analysis is linked to four strands of the literature. First, we relate to the literature on the formation of expectations under imperfect information. The study closest to us is [Andrade et al. \(2022\)](#) which examines the empirical plausibility of information frictions in the Lucas-island model by studying the relation between firms' expectations about aggregate variables and estimated industry-specific shocks. The literature includes studies that develop imperfect information in models with flexible prices ([Woodford, 2003](#); [Hellwig and Venkateswaran, 2009](#); [Crucini et al., 2015](#); [Afrouzi, 2024](#); [Kato et al., 2021](#); and [Melosi et al.,](#)

---

<sup>3</sup>See [Kaihatsu et al. \(2023\)](#) and [Bundick and Smith \(2020\)](#).



2024) and nominal price rigidities (Fukunaga, 2007; Nimark, 2008; Angeletos and La’O, 2009; Melosi, 2017; L’Huillier, 2020 and Li et al., 2026). We also relate to studies that allow for the coexistence of aggregate and idiosyncratic shocks in the presence of costly information acquisition (Veldkamp and Wolfers, 2007; and Acharya, 2017). Coibion et al. (2021) and Coibion et al. (2020) provide broad evidence on the relevance of firms’ expectations to firms’ decisions. Compared to the aforementioned studies, we provide novel evidence on firms’ expectations about aggregate and sector-specific components of demand and assess the role of expectations for the sensitivity of inflation to aggregate demand.

Second, our analysis relates to the literature that investigates the effect of imperfect information on the Phillips curve. Lucas (1973), using cross-country annual data, examines the implications of the Lucas (1972) model.<sup>4</sup> Mankiw and Reis (2002) and Dupor et al. (2010) develop sticky-information models to investigate the effect of informational frictions on the empirical performance of the Phillips curve. Coibion and Gorodnichenko (2015) establish that information frictions are critical in generating an empirically consistent formation of expectations that explain the missing disinflation between 2009 and 2011. Coibion et al. (2018) show that information frictions are important for formulating an empirically congruent Phillips curve. Afrouzi (2024) and Afrouzi and Yang (2021) investigate the effect of rational inattention on the Phillips curve, showing that the endogenous attention allocation of firms to economic variables is critical for the sensitivity of inflation to aggregate conditions. By contrast, Hellwig and Venkateswaran (2009) and Hellwig and Venkateswaran (2024) show that under imperfect information the sensitivity of prices to aggregate shocks can resemble that under perfect information only when aggregate and idiosyncratic shocks are equally persistent and strategic complementarities are weak. Our paper is consistent with this insight but focuses on aggregate versus sector-specific shocks rather than idiosyncratic ones. In our calibrated model, sector-specific shocks are less persistent than aggregate shocks, and strategic complementarities are strong, in line with standard calibrations in the literature.<sup>5</sup>

Third, we relate to studies that investigate changes in the sensitivity of inflation to economic slack, as generated by the anchoring effect of inflation targets (Roberts, 2004; L’Huillier and Zame, 2020; and Gáti, 2023), the increase in competition in the goods market

---

<sup>4</sup>Specifically, it shows that in a stable-price country, price adjustment is limited, and thus changes in nominal income affect real output. In contrast, in a volatile-price country, the impact on real output is muted due to flexible price adjustment. Alberro (1981) provides additional evidence.

<sup>5</sup>See Fernández-Villaverde et al. (2021, 2025) and Fernández-Villaverde et al. (2024) for recent studies on strategic complementarities in macroeconomic models.

(Sbordone, 2008; Zanetti, 2009; Kawamoto et al., 2025; and Holm et al., 2024), downward wage rigidities (Akerlof et al., 1996; Zanetti, 2007; and Faccini et al., 2013), and labor market frictions (Thomas and Zanetti, 2009; Zanetti, 2011; Chahrour et al., 2016; Cacciatore and Fiori, 2016; Pizzinelli et al., 2020; and Mitra, 2025), and supply chain issues (Bai et al., 2026a; and Bai et al., 2026b).<sup>6</sup> Unlike these studies, however, our focus is on the relationship between imperfect information and the sensitivity of inflation to changes in aggregate demand.

Finally, our analysis relates to studies that investigate the formation of expectations under imperfect information using firm-level survey data. Several studies focus on inflation expectations (Andrade et al., 2022 use a survey of French manufacturing firms, Coibion et al., 2020 and Bartiloro et al., 2017 use a survey of Italian firms, Kumar et al., 2015 use a survey of firms in New Zealand, L’Huillier et al., 2023 use the Survey of Professional Forecasters). We are the first to use a survey on Japanese firms to study the formation of expectations about the aggregate and sector-specific components of demand.

The remainder of the paper is organized as follows. Section 2 provides evidence on the co-movement in expectations about aggregate and sector-specific demand from survey data. It develops a simple model with imperfect information that explains the positive co-movement in the expectations of the separate components of demand. Section 3 augments the model to incorporate general equilibrium and derive equilibrium pricing with and without nominal rigidities. Section 4 studies the sensitivity of inflation dynamics to demand, and it shows that the data corroborates the theoretical predictions. Section 5 concludes.

## 2 Evidence from Survey Data

In this section, we analyze the relationship between firms’ expectations of the aggregate and sector-specific components of sectoral demand using survey data from Japan. We document a positive co-movement between expectations of sector-specific and aggregate demand, highlighting the important role of imperfect information in shaping these expectations, as we illustrate in the parsimonious model of imperfect information developed in Sections 3 and 4.

---

<sup>6</sup>Several studies show a decline in the sensitivity of inflation to real activity. See the survey by Mavroeidis et al. (2014) for a recent review of the literature on U.S. data. Kaihatsu et al. (2023) and Bundick and Smith (2020) provide evidence of the reduced sensitivity of inflation to real activity in Japanese data.

## 2.1 Empirical Assessment

The empirical analysis consists of two complementary approaches. First, we estimate the relationship between firms’ expectations of current sector-specific demand and aggregate demand. Second, we examine the relationship between firms’ expectations of the *future growth rate* of sector-specific demand and aggregate demand. Both approaches yield the same conclusion: firms’ expectations of sector-specific and aggregate demand components exhibit a positive and statistically significant co-movement.

We first describe the data used in the regression analyses and then present our empirical results.

**Survey Data.** We use two different datasets, the Business Outlook Survey and Annual Survey of Corporate Behavior. The Business Outlook Survey covers around 14,400 Japanese firms.<sup>7</sup> The survey is administered by the Cabinet Office and the Ministry of Finance starting in 2004. The survey is conducted quarterly and covers corporations with capital of 10 million yen or more (about 10 thousand firms) in 37 industries and three firm sizes (large, medium and small firms).<sup>8</sup>

The survey inquires about the direction of the current and future (one-quarter ahead) business conditions of the firms (“Business conditions”) and the broader macroeconomic conditions (“Domestic economic conditions”). Specifically, firms are requested to provide an assessment on the changes to demand relative to the previous quarter, choosing from the categories: “Rise,” “Unchanged,” “Fall,” and “Unknown.” The answers are aggregated in the Business Survey Index (BSI), providing the ratio of firms that choose “Rise” minus the ratio of firms that choose “Fall.”<sup>9</sup>

The design of the survey allows us to use the BSIs for firms of different sizes as proxies for firms’ sector-level average expectations regarding the growth of their sectoral demand and aggregate demand in the subsequent regressions.<sup>10</sup> Given that BSIs represent the average

---

<sup>7</sup>Appendix E provides a description and summary statistics for the Business Outlook Survey.

<sup>8</sup>Large firms are firms with capital of one billion yen or over, medium-sized firms are those with capital of 100 million to one billion yen, and small firms are those with capital of 10 million to 100 million yen.

<sup>9</sup>Specifically, the BSI is calculated by subtracting the composition ratio of corporations that chose “Falling” from composition ratio of corporations that chose “Rising.” For example, if 40 percent of the sampled firms choose “Rising” and 30 percent of them choose “Falling,” then BSI is “40 percent -30 percent=10 percent.” For details, see <https://www.mof.go.jp/english/pri/reference/bos/outline>.

<sup>10</sup>Since the published BSIs are those aggregated at industry-by-firm-size level rather than the industry level, we treat these series as sectoral data for the regression analysis.

expectations of multiple firms in each sector, we assume that firm-specific noise within each sector is washed out through aggregation.

We also use the Annual Survey of Corporate Behavior (ASCB) covering approximately 1,500 publicly listed Japanese firms.<sup>11</sup> The survey is administered by the Cabinet Office of Japan across 33 industries over the period 2003-2021. Firms complete a quantitative questionnaire that records the separate expectations about the one-year-ahead growth rate of the demand in their sectors and aggregate demand, thus providing an account of firms' expectations about the different aggregate and sector-specific components of total sectoral demand.<sup>12</sup> The sector-level averages of the surveyed firms' responses are publicly available, and we use these series in our regression analysis below. Again, firm-specific noise is assumed to be eliminated in the average expectations of multiple firms through aggregation.

**(i) Expectations on current sector-specific and aggregate demands.** We study the relationship between the expectations on the *current* sector-specific and aggregate demands. Specifically, we estimate the following equation using panel data for all industries  $i \in \mathcal{I}$ , where  $\mathcal{I}$  denotes the set of industries in the sample:

$$y_{i,t} = \alpha_i + \alpha_t + \alpha x_{i,t} + \epsilon_{i,t}, \quad (1)$$

where  $y_{i,t}$  represents the average expectations of firms in sector  $i$  in period  $t$  regarding changes in current aggregate demand, proxied by the sector-level BSIs related to broader macroeconomic conditions (“Domestic economic conditions”), taken from the Business Outlook Survey.<sup>13</sup>  $\alpha_i$  and  $\alpha_t$  denote the sector-level fixed effect and the time effect, respectively.  $x_{i,t}$  represents the average expectations of firms in sector  $i$  in period  $t$  regarding changes in current sectoral demand, proxied by the sector-level BSIs related to the business conditions of firms (“Business conditions”) from the Business Outlook Survey.  $\epsilon_{i,t}$  is the error term. While changes in sectoral demand ( $x_{i,t}$ ) may be driven by aggregate demand, the time effect ( $\alpha_t$ ) controls for common fluctuations across sectors. Consequently, the estimate of  $\alpha$  reflects the correlation between changes in firms' expectations about current sector-specific demand

---

<sup>11</sup>Appendix F provides a description and summary statistics for the ASCB.

<sup>12</sup>The question asked in the survey is: “Please enter a figure up to one decimal place in each of the boxes below as your rough forecast of Japan’s nominal economic growth rates and the nominal growth rates of demand in your industry for FY20XX”. The questionnaire of the survey is available at: <https://www.esri.cao.go.jp/en/stat/ank/ank-e.html>.

<sup>13</sup>While the survey publishes BSIs aggregated only at the industry-by-firm-size level rather than at the industry level, we treat these BSIs as representing different sectors. For example, we treat “Large&Construction” and “Small&Construction” as different sectors.

and those about current aggregate demand. A positive correlation would suggest that firms' expectations about current aggregate demand are influenced by sector-specific demand.

Table 1: Firms' expectations about current aggregate and sector-specific demand

| <i>Dataset: Business Outlook Survey; 2004/2Q-2023/1Q</i>                                                       |                        |                        |                            |                        |
|----------------------------------------------------------------------------------------------------------------|------------------------|------------------------|----------------------------|------------------------|
| <i>Dependent Variable: Assessment of general economic conditions in the current quarter (industry average)</i> |                        |                        |                            |                        |
|                                                                                                                | <i>(1) All samples</i> | <i>(2) Large firms</i> | <i>(3) Mid-sized firms</i> | <i>(4) Small firms</i> |
| <i>Assessment of own economic conditions in the current quarter (industry average)</i>                         | 0.54***<br>(0.02)      | 0.48***<br>(0.05)      | 0.50***<br>(0.03)          | 0.64***<br>(0.03)      |
| <i>Fixed effect</i>                                                                                            | Yes                    | Yes                    | Yes                        | Yes                    |
| <i>Period effect</i>                                                                                           | Yes                    | Yes                    | Yes                        | Yes                    |
| <i>Observations</i>                                                                                            | 7,864                  | 2,672                  | 2,672                      | 2,520                  |
| <i>Cross Section</i>                                                                                           | 109                    | 37                     | 37                         | 35                     |
| <i>Adjusted-R<sup>2</sup></i>                                                                                  | 0.83                   | 0.84                   | 0.83                       | 0.84                   |

*Note: Estimated by ordinary-least-squares. The standard errors are cross-section (sector) cluster robust standard errors.*

*\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.*

Table 1 shows the estimation results. The first column shows the estimates  $\hat{\alpha}$  for the entire sample, while the other columns display the estimates when focusing on samples from firms of different sizes. The table reveals that all estimates of  $\hat{\alpha}$  are positive and statistically significant at the one percent level. This suggests that firms' expectations about changes in aggregate demand are positively correlated with firms' expectations about changes in sector-specific demand, regardless of firm size.

**(ii) Expectations on future sector-specific and aggregate demands.** We next study the relationship between the expectations on the *future* sector-specific and aggregate demands. We first examine the relationship using the data from the Business Outlook Survey and then complement the results with data from the Annual Survey of Corporate Behavior. Specifically, we estimate the following equation using panel data for all industries:

$$y_{i,t} = \beta_i + \beta_t + \beta x_{i,t} + \epsilon_{i,t}, \quad (2)$$

where  $y_{i,t}$  represents firms' sector-level average expectations regarding changes in future aggregate demand, and  $x_{i,t}$  represents firms' sector-level average expectations regarding the growth rate of future sectoral demand.  $\beta_i$  and  $\beta_t$  denote the sector-specific and period fixed effects, respectively. The common fluctuations in  $x_{i,t}$  are accounted for by the time effect

( $\beta_t$ ), and thus the estimates of  $\beta$  capture the correlation between firms' expectations of future sector-specific demand growth and their expectations of future aggregate demand growth. In the analysis using the Business Outlook Survey,  $y_{i,t}$  is proxied by the sector-level BSIs related to future (one-quarter ahead) macroeconomic conditions, while  $x_{i,t}$  is proxied by the sector-level BSIs related to firms' own future economic conditions. For the analysis with the ASCB,  $y_{i,t}$  is proxied by firms' expectations of future (one-year ahead) nominal output growth, whereas  $x_{i,t}$  is proxied by firms' expectations of future (one-year ahead) nominal sectoral demand.

Table 2 presents the estimation results for  $\hat{\beta}$  using the Business Outlook Survey, showing that the correlation between firms' expectations of future aggregate demand and their expectations of sector-specific components of sectoral demand is positive and statistically significant at the one percent level.

Table 2: Firms' expectations on future aggregate and sector-specific demands

| <i>Dataset: Business Outlook Survey; 2004/2Q-2023/1Q</i>                                                    |                        |                        |                            |                        |
|-------------------------------------------------------------------------------------------------------------|------------------------|------------------------|----------------------------|------------------------|
| <i>Dependent Variable: Assessment of general economic conditions in the next quarter (industry average)</i> |                        |                        |                            |                        |
|                                                                                                             | <i>(1) All samples</i> | <i>(2) Large firms</i> | <i>(3) Mid-sized firms</i> | <i>(4) Small firms</i> |
| <i>Assessment of own economic conditions in the current quarter (industry average)</i>                      | 0.50***<br>(0.02)      | 0.42***<br>(0.06)      | 0.47***<br>(0.02)          | 0.57***<br>(0.02)      |
| <i>Fixed effect</i>                                                                                         | Yes                    | Yes                    | Yes                        | Yes                    |
| <i>Period effect</i>                                                                                        | Yes                    | Yes                    | Yes                        | Yes                    |
| <i>Observations</i>                                                                                         | 7,864                  | 2,672                  | 2,672                      | 2,520                  |
| <i>Cross Section</i>                                                                                        | 109                    | 37                     | 37                         | 35                     |
| <i>Adjusted-R<sup>2</sup></i>                                                                               | 0.72                   | 0.68                   | 0.72                       | 0.78                   |

*Note: Estimated by ordinary-least-squares. The standard errors are cross-section (sector) cluster robust standard errors.*

*\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.*

To ensure that these results are robust, we perform the same analysis using the data from ASCB. Table 3 shows the estimation results for  $\hat{\beta}$  using the ASCB, confirming a statistically significant positive correlation between firms' expectations of future aggregate demand and their expectations of the sector-specific components of future sectoral demand at the one-percent level.<sup>14</sup>

<sup>14</sup>The relatively small estimated coefficients in Table 3, compared to Tables 1 and 2, could be explained by the fact that heterogeneity (as measured by the standard deviation) in sample firms' expectations about future sectoral demand growth –relative to expectations about future aggregate demand growth– is three times higher in the ASCB than in the Business Outlook Survey. This difference likely arises because the former collects quantitative responses, while the latter relies on qualitative responses.

Table 3: Firms’ expectations on future aggregate and sector-specific demands

|                                                                                                  |                   |
|--------------------------------------------------------------------------------------------------|-------------------|
| <i>Dataset: Annual Survey of Corporate Behavior; 2003-2021</i>                                   |                   |
| <i>Dependent Variable: Expectations about Nominal output growth<sub>t</sub> (one-year ahead)</i> |                   |
| <i>Expectations about Nominal sectoral demand growth<sub>t</sub> (one-year ahead)</i>            | 0.06***<br>(0.02) |
| <i>Fixed effect</i>                                                                              | Yes               |
| <i>Period effect</i>                                                                             | Yes               |
| <i>Observations</i>                                                                              | 574               |
| <i>Cross Section</i>                                                                             | 33                |
| <i>Adjusted-R<sup>2</sup></i>                                                                    | 0.87              |

*Note: Estimated by ordinary-least-squares. The standard errors are cross-section (sector) cluster robust standard errors. \*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.*

To summarize, our results from both types of analyses consistently demonstrate that the positive co-movement between firms’ expectations of aggregate and sector-specific components of demand is a significant characteristic of firms’ expectations.

## 2.2 Expectations under Imperfect Information

To link the significance of the positive co-movement of the firms’ expectations about the components of aggregate and sector-specific demand observed in survey data with imperfect information, we develop a parsimonious model of imperfect information on the different components of demand—aggregate and sector-specific shocks following [Mackowiak and Wiederholt \(2009\)](#). We will extend the model to a general equilibrium framework to study the implications for the sensitivity of inflation to demand in [Section 3](#).

We assume the economy is populated by a representative household and a continuum of monopolistic competitive firms that produce differentiated goods indexed by  $j \in [0, 1]$  in a continuum of sectors indexed by  $i \in [0, 1]$ . Each firm  $j$  in sector  $i$  observes total sectoral demand ( $x_t(i)$ ) that changes in response to aggregate demand and sector-specific demand, according to  $x_t(i) = q_t + v_t(i)$ , without observing the separate realizations for the aggregate ( $q_t$ ) and sector-specific components ( $v_t(i)$ ).<sup>15</sup> Aggregate demand follows the

<sup>15</sup>We will derive and revisit this relation in a general equilibrium framework in [Section 3](#). A recent study by [Chahrour and Ulbricht \(2019\)](#) shows that imperfect information on disaggregate shocks of the type we have in our simple model generates realistic business cycle statistics.

stochastic process:

$$q_t = q_{t-1} + u_t, \quad (3)$$

where  $u_t$  is an AR(1) process:

$$u_t = \rho_u u_{t-1} + e_t, \quad (4)$$

with  $0 \leq \rho_u < 1$ , and  $e_t \sim \mathcal{N}(0, \sigma_t^2)$ . The sector-specific demand follows the AR(1) process:

$$v_t(i) = \rho_v v_{t-1}(i) + \epsilon_t(i), \quad (5)$$

where  $-1 < \rho_v < 1$ , and  $\epsilon_t(i) \sim \mathcal{N}(0, \tau_t^2)$ .

To simplify notation, we label  $\tilde{x}_t(i) = \Delta x_t(i)$ ,  $\tilde{v}_t(i) = \Delta v_t(i)$ , and  $u_t = \Delta q_t$  by using equation (3). Combining equations (4)-(5), we write the change in total sectoral demand,  $\tilde{x}_t(i)$ , as the sum of the change in aggregate demand,  $u_t$ , and the change in sector-specific demand,  $\tilde{v}_t(i)$ :

$$\tilde{x}_t(i) = u_t + \tilde{v}_t(i). \quad (6)$$

In each period  $t$ , firms set prices without observing the current aggregate and sector-specific components of total sectoral demand and therefore are unable to infer the current aggregate price.<sup>16</sup> Thus, each firm uses information from the common signal of total sectoral demand (i.e.,  $x_t(i) = q_t + v_t(i)$ ) and the past realizations of aggregate and sector-specific components of demand to make inference on the current components of aggregate ( $q_t$ ) and sector-specific demand ( $v_t(i)$ ), such that  $q_t \sim \mathcal{N}(q_{t-1} + \rho_u u_{t-1}, \sigma_t^2)$  and  $v_t(i) \sim \mathcal{N}(\rho_v v_{t-1}(i), \tau_t^2)$ .<sup>17</sup> Hence, in each period  $t$ , the information set for the firms in sector  $i$  is:

$$\mathcal{H}_t(i) \equiv \left\{ \{x_s(i)\}_{s=0}^t, \{q_s, u_s, v_s(i), e_s, \epsilon_s(i)\}_{s=0}^{t-1} \right\}, \quad (7)$$

and hereafter we denote the expectations under imperfect information as:  $\mathbb{E}_t \equiv \mathbb{E}[\bullet | \mathcal{H}_t(i)]$ .

In what follows, we show that imperfect information on the *current* components of demand explains the observed positive correlation between firms' expectations on aggregate and sector-specific components of total sectoral demand.

---

<sup>16</sup>The assumption that  $q_t$  is unobservable in period  $t$  implies that the labor market clears after firms set prices. Therefore, firms base their profit-maximizing decisions on the expected nominal wage in period  $t$ , as in Angeletos and La'O (2009).

<sup>17</sup>See Guerron-Quintana et al. (2018) for an overview on solutions for filtering problems in economics.



**Mapping the model to the data.** In the context of this model, Table 1 in Section 2 establishes the positive correlation between  $\mathbb{E}_t[u_t]$  and  $\tilde{v}_t(i)$ , and Table 3 indicates the positive correlation between  $\mathbb{E}_t[\sum_{h=1}^4 u_{t+h}]$  and  $\mathbb{E}_t[\sum_{h=1}^4 \tilde{v}_{t+h}(i)]$ . Under perfect information, they never hold as firms can separate aggregate demand from sector-specific demand that are orthogonal. However, in the following propositions, we show that the information structures above can explain our empirical observations.

First, the following proposition shows the structures of the firms' expectations under the information structures.

**Proposition 1** *If total demand comprises unobservable aggregate and sector-specific components (i.e.,  $\tilde{x}_t(i) = u_t + \tilde{v}_t(i)$ ), the expectations at time  $t$  about the changes in aggregate and sector-specific demands are equal to:*

$$\mathbb{E}_t[u_t] = \rho_u u_{t-1} + \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} [e_t + \epsilon_t(i)] \quad (8)$$

and

$$\mathbb{E}_t[\tilde{v}_t(i)] = (\rho_v - 1)v_{t-1}(i) + \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} [e_t + \epsilon_t(i)], \quad (9)$$

respectively.

**Proof:** See Appendix D.1.  $\square$

Equations (8) and (9) show that firm's expectations on the changes in aggregate and sector-specific demand depend on the changes in sectoral demand, which comprises shocks to aggregate and sector-specific shocks ( $e_t + \epsilon_t(i)$ ) that the firm cannot separately observe. The response of each expectation to movement in total sectoral demand depends on the ratio  $\tau_t/\sigma_t$ , which represents the volatility of sector-specific shocks relative to aggregate shocks. As the volatility of the shock to sector-specific demand is larger than the volatility of the shock to aggregate demand (i.e.,  $\tau_t/\sigma_t > 1$ ) – reflecting the fact that changes in total sectoral demand are predominantly driven by the sector-specific component of demand – the response of firms' expectations about the sector-specific component of demand to the change in total sector demand increases while the response of firms' expectations on the aggregate component of demand to total sectoral demand decreases.

The next propositions characterize the sign of the co-movement between the expectations of *current* aggregate and sector-specific demand, observed in Table 1.

**Proposition 2** *If total demand comprises unobservable aggregate and sector-specific components, the co-movement in the current expectations about aggregate and sector-specific demand, conditional on the information set in the previous period, is equal to:*

$$\mathbb{C}(\mathbb{E}_t[u_t], \mathbb{E}_t[\tilde{v}_t(i)] | \mathcal{F}_{t-1}) = \frac{\sigma_t^2 \tau_t^2}{\sigma_t^2 + \tau_t^2} > 0, \quad (10)$$

where  $\mathbb{C}(\cdot)$  is the unconditional covariance operator and  $\mathcal{F}_{t-1}$  is information available in period  $t - 1$ .

**Proof:** See Appendix D.2.  $\square$

Proposition 2 shows that the presence of imperfect information generates a positive co-movement between the expectations of *current* aggregate and sector-specific components of total sectoral demand. Given the non-zero persistence of aggregate and sector-specific shocks (equations (4) and (5)), this generates a positive co-movement between the expectations about the components of 4-period (one-year) ahead demand, empirically observed in Table 3, as shown in the next proposition.

**Proposition 3** *If total demand comprises unobservable aggregate and sector-specific components, the positive co-movement in the current expectations generates the positive co-movement in the 4-period ahead expectations:*

$$\mathbb{C}(\mathbb{E}_t[u_t], \mathbb{E}_t[\tilde{v}_t(i)] | \mathcal{F}_{t-1}) > 0 \Rightarrow \mathbb{C}\left(\mathbb{E}_t\left[\sum_{h=1}^4 u_{t+h}\right], \mathbb{E}_t\left[\sum_{h=1}^4 \tilde{v}_{t+h}(i)\right] | \mathcal{F}_{t-1}\right) > 0.$$

**Proof:** See Appendix D.3.  $\square$

Proposition 3 provides the theoretical underpinning that imperfect information generates the positive correlation between the expectations on future aggregate and sector-specific components of demand. To sum up, the analysis shows that imperfect information on the distinct components of current sectoral demand is critical to replicate the positive co-movement in the expectations of aggregate and sector-specific components of demand observed in the data.

### 3 General Equilibrium

To study the implications of imperfect information on firms' price setting and the resulting link between inflation and economic activity, this section embeds the expectations based

on imperfect information regarding distinct components of sectoral demand in a general equilibrium framework.

### 3.1 Model

The model is based on [Woodford \(2003\)](#), [Angeletos and La'O \(2009\)](#), and [Mackowiak et al. \(2009a\)](#). We maintain the information structure as in [Lucas \(1972\)](#) developed in the previous section and enrich the model with nominal price rigidities. The economy is populated by a representative household and a continuum of monopolistic competitive firms that produce differentiated goods, indexed by  $j \in [0, 1]$  in a continuum of sectors, indexed by  $i \in [0, 1]$ . The representative household consumes the whole income with no saving in equilibrium. Monopolistic competitive firms face a total sectoral demand that comprises aggregate and sector-specific shocks, as described in equations (3), (4), and (5). Firms observe current total sectoral demand and the past realizations of aggregate and sector-specific shocks to demand, but they are unable to separately observe the realizations of aggregate and sector-specific components of total sectoral demand in real time. Namely, firms form expectations at time  $t$ , using the information set  $\mathcal{H}_t(i)$  in equation (7).

The rest of the section develops the problems of households and firms and derives the equilibrium.

**Households.** The following utility function describes the preferences of the representative household over consumption,  $C_t$ , and labor,  $N_t$ :

$$\sum_{t=0}^{\infty} \beta^t (\log C_t - N_t),$$

where  $\beta \in (0, 1)$  is the discount rate. The household's aggregate consumption,  $C_t$ , and consumption of goods in sector  $i$ ,  $C_t(i)$ , are defined by the CES consumption aggregators:

$$C_t \equiv \left[ \int_0^1 (C_t(i) \Theta_t(i))^{\frac{\eta-1}{\eta}} di \right]^{\frac{\eta}{\eta-1}}, \text{ and } C_t(i) \equiv \left[ \int_0^1 (C_t(i, j))^{\frac{\tilde{\eta}-1}{\tilde{\eta}}} dj \right]^{\frac{\tilde{\eta}}{\tilde{\eta}-1}},$$

where  $\eta > 1$  is the elasticity of substitution across sectors,  $\tilde{\eta} > 1$  is the elasticity of substitution across goods within the same sector,  $C_t(i, j)$  is consumption of good  $j$  in sector  $i$ , and  $\Theta_t(i)$  is the sector-specific preference shocks (defined below).

**Firms.** Each firm  $j$  in sector  $i$  (referred to as “firm  $(i, j)$ ”) faces the following demand:

$$C_t(i, j) = \Theta_t^{\eta-1}(i) \left( \frac{P_t(i, j)}{P_t(i)} \right)^{-\tilde{\eta}} \left( \frac{P_t(i)}{P_t} \right)^{-\eta} C_t, \quad (11)$$

where  $P_t(i) \equiv \left[ \int_0^1 P_t^{1-\tilde{\eta}}(i, j) dj \right]^{\frac{1}{1-\tilde{\eta}}}$  is the price index for sector  $i$ ,  $P_t \equiv \left[ \int_0^1 P_t^{1-\eta}(i) \Theta_t^{\eta-1}(i) di \right]^{\frac{1}{1-\eta}}$  is the aggregate price index, and the sector-specific preference shock,  $\Theta_t(i)$ , acts as an exogenous demand shifter for firm  $(i, j)$ .<sup>18</sup>

Each firm  $(i, j)$  manufactures a single good  $Y(i, j)$ , according to the production technology:

$$Y_t(i, j) = AL_t^\epsilon(i, j), \quad (12)$$

where  $A$  is aggregate productivity and  $\epsilon \in (0, 1)$  determines the degree of diminishing marginal returns in production.

**Market Clearing.** In a symmetric equilibrium, market clearing implies  $Y_t(i, j) = C_t(i, j)$  for each firm  $(i, j)$  and thus  $Y_t = C_t$  in the economy. Aggregate nominal demand,  $Q_t$ , is given by the following cash-in-advance constraint:

$$Q_t = P_t C_t.$$

In the rest of the analysis, we use lower-case variables to indicate logarithm of the corresponding upper-case variables (i.e.,  $x_t \equiv \log X_t$ ).

**Optimal Price-Setting Rule and Total Sectoral Demand.** In what follows, we derive the optimal price-setting rule as a function of total sectoral demand.

During each period  $t$ , the firm  $(i, j)$  sets the optimal price as a mark-up over the marginal cost:

$$p_t(i, j) = \mu + mc_t(i, j), \quad (13)$$

where  $\mu \equiv \tilde{\eta}/(\tilde{\eta} - 1) > 0$  is the mark-up and  $mc_t(i, j)$  is the nominal marginal cost faced by firm  $(i, j)$ . The nominal marginal cost is the difference between the nominal wage,  $w_t$ , and the marginal product of labor:

$$mc_t(i, j) = w_t + (1 - \epsilon) l_t(i, j) - a - \log(\epsilon). \quad (14)$$

---

<sup>18</sup>See Appendix A for the derivation of the demand function for each firm  $(i, j)$  and price indexes.

Using the production technology in equation (12), we express labor input as:  $l_t(i, j) = [y_t(i, j) - a]/\epsilon$ , and we use it in equation (14) to rewrite the nominal marginal cost as:

$$mc_t(i, j) = w_t + \frac{1 - \epsilon}{\epsilon} y_t(i, j) - \frac{1}{\epsilon} a - \log(\epsilon).$$

The optimal labor supply condition for the representative household is:

$$w_t - p_t = c_t, \quad (15)$$

and the linearized consumer demand in equation (11) is:

$$c_t(i, j) = -\tilde{\eta} (p_t(i, j) - p_t(i)) - \eta (p_t(i) - p_t) + c_t + (\eta - 1) \zeta_t(i), \quad (16)$$

where the sector-specific preference shock,  $\zeta_t(i)$ , follows the AR(1) process:

$$\zeta_t(i) = \rho_v \zeta_{t-1}(i) + \tilde{\epsilon}_t(i), \quad (17)$$

and  $\tilde{\epsilon}_t(i) \sim \mathcal{N}(0, (1 - \epsilon)^{-2} (\eta - 1)^{-2} \tau_t^2)$ .<sup>19</sup>

We derive the optimal price-setting rule for firm  $(i, j)$  by using equations (15), (16), the equilibrium conditions,  $y_t(i, j) = c_t(i, j)$ ,  $y_t = c_t$ , and the cash-in-advance constraint,  $y_t = q_t - p_t$ , which yields:<sup>20</sup>

$$p_t(i, j) = r_1 p_t(i) + r_2 p_t + (1 - r_1 - r_2) x_t(i) + \xi, \quad (18)$$

where

$$x_t(i) = q_t + v_t(i), \quad (19)$$

$$v_t(i) = (1 - \epsilon) (\eta - 1) \zeta_t(i), \quad (20)$$

$$\xi = \frac{\epsilon}{\epsilon + \tilde{\eta} (1 - \epsilon)} (\mu - \frac{1}{\epsilon} a - \log(\epsilon)), \quad (21)$$

$$r_1 = \frac{(\tilde{\eta} - \eta) (1 - \epsilon)}{\epsilon + \tilde{\eta} (1 - \epsilon)}, \quad (22)$$

$$r_2 = \frac{(\eta - 1) (1 - \epsilon)}{\epsilon + \tilde{\eta} (1 - \epsilon)}, \quad (23)$$

and  $p_t = \int_0^1 p_t(i) di$ .<sup>21</sup> Equation (18) shows that the optimal pricing rule for firm  $(i, j)$  is a weighted average of the sectoral prices  $(p_t(i))$ , aggregate prices  $(p_t)$ , and total sectoral

<sup>19</sup>Note that the information set is augmented with  $p_s, \zeta_s(i)$ , and  $\tilde{\epsilon}_t(i)$ . Namely, the following is the observed variables at time  $t$ :  $\mathcal{H}_t(i) \equiv \{\{x_s(i)\}_{s=0}^t, \{p_s, q_s, u_s, v_s(i), \zeta_s(i), e_s, \epsilon_s(i), \tilde{\epsilon}_s(i)\}_{s=0}^{t-1}\}$ . All propositions in the previous section continue to hold.

<sup>20</sup>Appendix C shows the derivation of the price setting rule.

<sup>21</sup>Appendix B shows the derivation of the index of aggregate prices.

demand ( $x_t(i)$ ), which adds aggregate and sector-specific demand (i.e.,  $x_t(i) = q_t + v_t(i)$ ). The weights on each term of equation (18) are determined by the parameters  $r_1$  and  $r_2$ , which reflect the degree of strategic complementarity among firms in the same sector and across sectors, respectively. Equation (19) shows that total sectoral demand ( $x_t(i)$ ) is the sum of aggregate ( $q_t$ ) and sector-specific components ( $v_t(i)$ ). Equation (20) shows that the sector-specific demand depends on the sector-specific preference shock  $\zeta_t(i)$ . The constant parameter  $\xi$ , defined by equation (21), is a linear transformation of the level of aggregate productivity,  $a$ . By normalizing aggregate productivity such that  $\xi = 0$ , the price level for firm  $(i, j)$  is uniquely determined by sector-specific and aggregate prices and total sectoral demand.<sup>22</sup>

Since firms in the same sector face the same marginal costs and have access to the same information,  $p_t(i) = p_t(i, j) = p_t(i, j')$  for  $j \neq j'$  in equilibrium, and equation (18) reduces to:

$$p_t(i) = r p_t + (1 - r) x_t(i), \quad (24)$$

where

$$r \equiv \frac{r_2}{1 - r_1} = \frac{(\eta - 1)(1 - \epsilon)}{\epsilon + \eta(1 - \epsilon)}.$$

Equation (24) shows that the optimal pricing rule for firm  $(i, j)$  is a weighted average of aggregate prices ( $p_t$ ) and total sectoral demand ( $x_t(i)$ ). The weights for average prices and total sectoral demand are determined by the parameter  $r$ , which reflects the degree of strategic complementarity between firms in different sectors, consistent with equation (18).<sup>23</sup>

### 3.2 Nominal Price Rigidities

To account for the potential presence of nominal price rigidities in the firms' price-setting behavior, we enrich the model with nominal price rigidities that prevent firms from optimally adjusting prices in each period.

We embed nominal price rigidities, as in Calvo (1983), by assuming that a firm maintains the same price with exogenous probability  $\theta \in (0, 1)$  and otherwise changes the price

---

<sup>22</sup>Note that setting  $\xi = 0$  is irrelevant for inflation since  $\xi$  affects the price level only.

<sup>23</sup>Equation (24) shows that if production technology converges to constant returns (i.e.,  $\epsilon \rightarrow 1$ ), average prices become less important in the determination of the price for firm  $i$  (i.e.,  $r \rightarrow 0$ ) since the marginal cost converges to the aggregate nominal wage across firms (i.e.,  $mc_t(i) \rightarrow w_t$ ) and heterogeneity in the firms' prices decreases. The magnitude of the sector-specific shock decreases (i.e.,  $v_t(i) \rightarrow 0$ ) as the production technology converges to constant returns (i.e.,  $\epsilon \rightarrow 1$ ). As a result, in the limiting case of a linear production technology (i.e.,  $\epsilon = 1$ ), the optimal pricing rule is  $p_t(i) = q_t + \xi$ .

optimally based on the expectations of demand. The optimal reset price for firms in sector  $i$ , denoted by  $p_t^*(i)$ , depends on expectations formed at time  $t$  on present and future prices, as described by the pricing rule:

$$\begin{aligned} p_t^*(i) &= (1 - \beta\theta) \sum_{j=0}^{\infty} (\beta\theta)^j \mathbb{E}_t[p_{t+j}(i)] \\ &= (1 - \beta\theta) \sum_{j=0}^{\infty} (\beta\theta)^j [r\mathbb{E}_t[p_{t+j}] + (1 - r)\mathbb{E}_t[x_{t+j}(i)]], \end{aligned} \quad (25)$$

where the second equation is derived by substituting the optimal pricing rule in equation (24). Unlike standard full-information rational expectations models, the expectations in equation (25) are formed under imperfect information, and they are determined in accordance to Proposition 1. Equation (25) shows that each firm in sector  $i$  sets prices as a weighted average of the firm's expectations about current and expected future prices, and the expectations are formed based on the information available at time  $t$ . Since expectations about total sectoral demand ( $\mathbb{E}_t[x_{t+j}(i)]$ ) depend on the different aggregate and sector-specific components of demand, the co-movement of these components is critical to set the price.

**The Equilibrium Average Price.** Equation (25) provides the equilibrium average price once we derive the expectations for prices and total sectoral demand. The model is sufficiently simple to provide an analytical solution for the equilibrium average price, characterized in the next proposition.

**Proposition 4** *The equilibrium average price and sectoral price are given by:*

$$p_t = [\theta + (1 - \theta)a_1] p_{t-1} + (1 - \theta) a_2 q_t + (1 - \theta) a_3 q_{t-1} + (1 - \theta) a_4 u_{t-1}, \quad (26)$$

$$p_t(i) = p_t + (1 - \theta) a_2 v_t(i) + a_5 v_{t-1}(i) \quad (27)$$

where  $(a_1, a_2, a_3, a_4, a_5)$  are non-linear functions of the ratio in the volatility of sector-specific to aggregate shocks  $(\tau_t/\sigma_t)$ . In an extreme case of flexible prices ( $\theta = 0$ ),  $a_1 = 0$  holds and the equilibrium average price and sectoral price are given by:

$$p_t = a_2 q_t + a_3 q_{t-1} + a_4 u_{t-1}, \quad (28)$$

$$p_t(i) = p_t + a_2 v_t(i) + a_5 v_{t-1}(i) \quad (29)$$

**Proof:** See Appendix D.4.  $\square$

Equations (26) and (27) show that the equilibrium aggregate and sectoral price depend on the equilibrium price in the period  $t - 1$  ( $p_{t-1}$ ) and the sequence of present and past demands ( $q_t, v_t(i), q_{t-1}, v_{t-1}(i)$ ). Similarly, equations (28) and (29) show that the equilibrium aggregate and sectoral price depend on the sequence of present and past demands ( $q_t, v_t(i), q_{t-1}, v_{t-1}(i)$ ), while not depending on the equilibrium price in the period  $t - 1$  ( $p_{t-1}$ ). Important to our subsequent analysis, the proposition shows that the relative volatility of sector-specific shocks compared to aggregate shocks, encapsulated by the ratio  $\tau_t/\sigma_t$ , plays a critical role for the sensitivity of the aggregate price to present and past aggregate demands, as we study in the next section.

## 4 Demand Shocks and Inflation Dynamics

Using the definition of the average price in equation (26) and the sectoral price in equation (27), we derive the analytical solution for the aggregate and sectoral inflation rate, defined as the change in the average and sectoral price from period  $t - 1$  to period  $t$  ( $\pi_t \equiv p_t - p_{t-1}$  and  $\pi_t(i) \equiv p_t(i) - p_{t-1}(i)$ ), as characterized by the next proposition.

**Proposition 5** *Under imperfect information on aggregate and sector-specific demand shocks, average price inflation ( $\pi_t$ ) and sectoral price inflation ( $\pi_t(i)$ ) are equal to:*

$$\begin{aligned}\pi_t &= [\theta + (1 - \theta)a_1] \pi_{t-1} + (1 - \theta) a_2 u_t + (1 - \theta) (a_3 + a_4) u_{t-1} - (1 - \theta) a_4 u_{t-2} \\ &= \alpha_1 \pi_{t-1} + \alpha_2 u_t + \alpha_3 u_{t-1} + \alpha_4 u_{t-2},\end{aligned}\tag{30}$$

$$\pi_t(i) = \pi_t + (1 - \theta) a_2 \tilde{v}_t(i) + a_5 \tilde{v}_{t-1}(i) = \pi_t + \alpha_2 \tilde{v}_t(i) + \alpha_5 \tilde{v}_{t-1}(i),\tag{31}$$

where  $\alpha_1 \equiv \theta + (1 - \theta)a_1$ ,  $\alpha_2 \equiv (1 - \theta)a_2$ ,  $\alpha_3 \equiv (1 - \theta)(a_3 + a_4)$ ,  $\alpha_4 \equiv -(1 - \theta)a_4$ , and  $\alpha_5 \equiv (1 - \theta)a_5$ . In an extreme case of flexible prices ( $\theta = 0$ ),  $a_1 = 0$  holds and the equilibrium average price and sectoral price inflation are given by:

$$\pi_t = a_2 u_t + (a_3 + a_4) u_{t-1} - a_4 u_{t-2} = \alpha_2 u_t + \alpha_3 u_{t-1} + \alpha_4 u_{t-2},\tag{32}$$

$$\pi_t(i) = \pi_t + a_2 \tilde{v}_t(i) + a_5 \tilde{v}_{t-1}(i) = \pi_t + \alpha_2 \tilde{v}_t(i) + \alpha_5 \tilde{v}_{t-1}(i).\tag{33}$$



**Proof:** Taking the first difference of the equations (26) and (27) yields equations (30) and (31), respectively. Similarly taking the first difference of equations (28) and (29) yields equations (32) and (33), respectively.  $\square$

Equations (30) and (31) provide the analytical solution to aggregate and sectoral inflation under imperfect information, respectively. Equation (30) shows that current inflation ( $\pi_t$ ) depends on past inflation ( $\pi_{t-1}$ ) and current and past changes in aggregate demand ( $u_t$ ,  $u_{t-1}$ , and  $u_{t-2}$ , respectively), stemming from the assumption that demand in the past period  $t - 1$  is fully revealed in the current period  $t$ .<sup>24</sup> Similarly, equation (31) shows that current sectoral inflation ( $\pi_t(i)$ ) depends on past average inflation ( $\pi_{t-1}$ ) and current changes in total sectoral demand and past changes in aggregate and sector-specific demand ( $\tilde{x}_t(i)$ ,  $u_{t-1}$ , and  $\tilde{v}_{t-1}(i)$ , respectively). The effect of  $\tau_t/\sigma_t$  on the coefficients ( $\alpha_2, \alpha_3, \alpha_4, \alpha_5$ ) is non-linear, and it interacts with the degree of nominal price rigidities  $\theta$ .<sup>25</sup> Equations (32) and (33) in Proposition 5 show that if prices are flexible ( $\theta = 0$ ), the parameter  $\alpha_1$  is equal to zero, showing that nominal price rigidities are the main driver of inflation persistence in this reduced form inflation dynamics. Since the effect of  $\tau_t/\sigma_t$  on coefficients for equations (30) and (31),  $\alpha_1, \alpha_2, \alpha_3, \alpha_4$ , and  $\alpha_5$ , is highly non-linear and interplays with the degree of nominal price rigidities, we rely on numerical simulations to study the sensitivity of inflation to demand in the next subsection. Note that in an extreme case of flexible price inflation, the relationship between  $\tau_t/\sigma_t$  and coefficients for equations (32) and (33),  $\alpha_2, \alpha_3, \alpha_4$ , and  $\alpha_5$ , can be analytically derived as follows.

**Proposition 6**  *$\alpha_2$  and  $\alpha_4$  are decreasing in  $\tau_t/\sigma_t$ , while  $\alpha_3$  is increasing. The relationship between  $\alpha_5$  and  $\tau_t/\sigma_t$  depends on the sign of  $\rho_v$  as the positive relationship holds if  $\rho_v > 0$  and vice versa.*

**Proof:** See Appendix D.5.  $\square$

Proposition 6 indicates that average and sectoral inflation in equations (32) and (33) respond more weakly to changes in aggregate demand ( $u_t$ ) and sector-specific demand ( $\tilde{v}_t(i)$ ), respectively, when  $\tau_t/\sigma_t$  is higher.

---

<sup>24</sup>The dynamics for inflation is related to Angeletos and La'O (2009), but it differs across two important dimensions. First, the coefficients ( $\alpha_2, \alpha_3, \alpha_4, \alpha_5$ ) depend on the volatility of sector-specific shocks ( $\tau^2$ ), and second, inflation depends on the changes in demand two periods before  $u_{t-2}$  since aggregate shocks are persistent.

<sup>25</sup>See Appendix D.4 for the characterization of parameters  $a_1, a_2, a_3, a_4$ , and  $a_5$ .

Finally, we derive the Phillips curve under the simplified assumption  $\rho_u = \rho_v = 0$ .

**Corollary 1** *Suppose  $\rho_u = \rho_v = 0$ . The Phillips curve is given as follows:*

$$\pi_t = \frac{\alpha_2}{1 - \alpha_2} y_t + \frac{\alpha_3}{1 - \alpha_2} y_{t-1}, \quad (34)$$

**Proof:** See Appendix D.6.  $\square$

Corollary 1 shows the equation for aggregate inflation, which has no lagged inflation term (i.e. inflation persistence), as in the standard New Keynesian Phillips curve.<sup>26</sup> The lagged output gap emerges because firms face imperfect information about current economic variables, and thus the expectations depend on past economic variables.

## 4.1 Numerical Simulations

The model shows that imperfect information makes the response of average and sectoral inflation to demand a non-linear function of the ratio of volatility of the sector-specific to aggregate shock ( $\tau_t/\sigma_t$ ) and the degree of nominal rigidities ( $\theta$ ), which jointly determine the response of inflation to demand, as encapsulated by the coefficients  $\alpha_1$ ,  $\alpha_2$ ,  $\alpha_3$ ,  $\alpha_4$ , and  $\alpha_5$  in equations (30) and (31). In this section, we use numerical simulations to study the sensitivity of inflation to demand.

**Sensitivity of Inflation to Changes in Demand.** We simulate the model using a standard calibration. We set  $\beta = 0.99$ ,  $\eta = 8$ ,  $\epsilon = 2/3$ , and  $r = [(\eta - 1)(1 - \epsilon)] / [\epsilon + \eta(1 - \epsilon)] = 0.7$ .

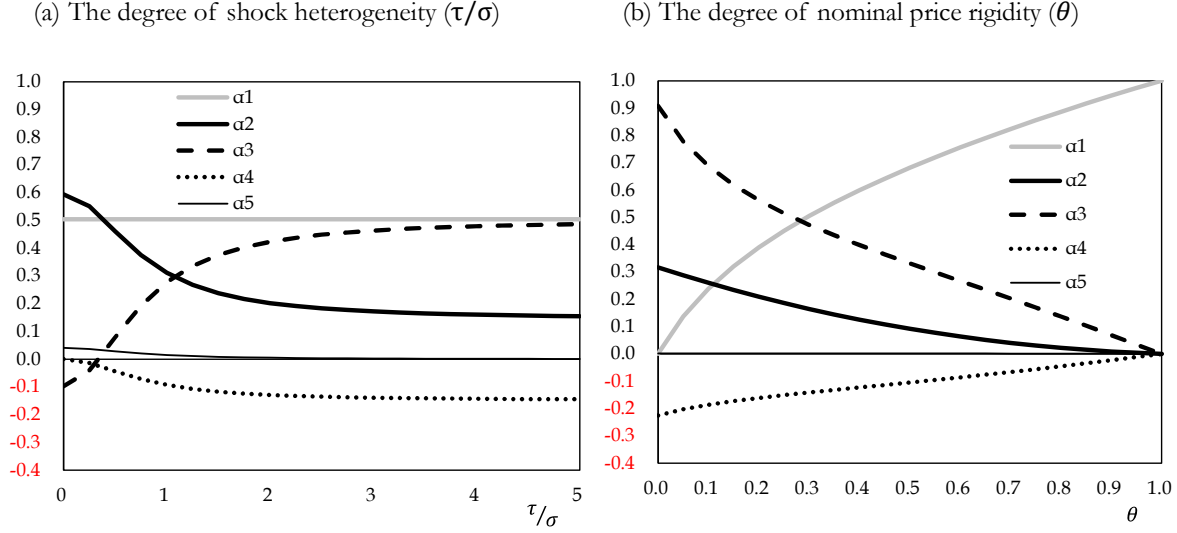
To investigate the role of shock heterogeneity, we allow the ratio  $\tau_t/\sigma_t \in [0, 5]$  to cover a wide range of values, while the baseline calibration is  $\tau_t/\sigma_t = 3.5$ . We will estimate this ratio in the next section. Similarly, we allow the degree of nominal price rigidity  $\theta \in [0, 1]$  to cover the whole range of admissible values. Additionally, we set the parameters for the persistence of aggregate and sector-specific shocks equal to  $\rho_u = 0.33$  and  $\rho_v = -0.09$  to replicate the estimates of first-order auto-correlation in Table A10 for both the aggregate and the median of sector-specific components of demand.

Figure 1 in panel (a) shows the coefficients  $\alpha_1$ ,  $\alpha_2$ ,  $\alpha_3$ ,  $\alpha_4$ , and  $\alpha_5$  for different values of the relative volatility of sector-specific shocks (i.e.,  $\tau_t/\sigma_t$ ). The coefficient  $\alpha_1$  on past inflation is insensitive to  $\tau_t/\sigma_t$ , evincing that the relative volatility of sector-specific shocks plays no

---

<sup>26</sup>Inflation expectations do not appear in the equation for inflation since they are determined by the linear combination of current and past economic variables in the information structure of the model.

Figure 1: Sensitivity of coefficients



Notes: Parameters are  $\theta = 0.3$ ,  $r = 0.7$ ,  $\beta = 0.99$ ,  $\rho_u = 0.33$ ,  $\rho_v = -0.09$  for (a), and  $\tau/\sigma = 3.5$ ,  $r = 0.7$ ,  $\beta = 0.99$ ,  $\rho_u = 0.33$ ,  $\rho_v = -0.09$  for (b).

role in the relation between current inflation and past inflation, which instead is determined by the degree of nominal price rigidities, as we discuss below. The coefficient  $\alpha_2$  on current aggregate and sector-specific demand is instead highly sensitive to the relative volatility of sector-specific shocks, and inflation becomes less responsive to changes in current demand (i.e.,  $\alpha_2$  decreases) when  $\tau_t/\sigma_t$  increases. Strategic complementarity in the optimal price-setting, encapsulated by  $r > 0$  in equation (24), induces the firm to hold the adjustment of prices if it attributes that the change in total sectoral demand is generated by the sector-specific component. Therefore, *ceteris paribus*, an increase in the volatility of the sector-specific component of demand decreases the response of prices to changes in total sectoral demand. The coefficient  $\alpha_3$  (past lag of aggregate demand) increase while the coefficient  $\alpha_4$  (past two lags of aggregate demand) and  $\alpha_5$  (past lag of sector-specific demand) decrease in response to the increase in  $\tau_t/\sigma_t$ . The response of inflation is on average more sensitive to movements in past lags of demand. Overall, the numerical simulations show that the parameter  $\alpha_2$ , which internalizes the effect of changes in  $\tau_t/\sigma_t$ , plays a critical role in the sensitivity of inflation to demand. Note that these properties of the coefficients are fully consistent with those under flexible prices, as shown in Proposition 6.

Figure 1 in panel (b) shows the sensitivity of coefficients  $\alpha_1$ ,  $\alpha_2$ ,  $\alpha_3$ ,  $\alpha_4$ , and  $\alpha_5$  to changes in the degree of nominal price rigidity ( $\theta$ ) in the inflation equation (30). The increase in nominal price rigidities generates a rise in the coefficient  $\alpha_1$  since a low frequency

of price adjustment increases the importance of past inflation in the determination of current inflation. The increase in the degree of nominal price rigidity generates a decrease in the absolute value of the coefficients  $\alpha_2$ ,  $\alpha_3$ ,  $\alpha_4$  and  $\alpha_5$  since the sensitivity of individual prices to movements in current demand is lowered by the increase in nominal price rigidity ( $\theta$ ). As the degree of nominal price rigidity increases, these parameters converge to zero. This makes a stark contrast from the case of higher shock heterogeneity where the influence of past shocks increases by directly changing the coefficients on the past shocks ( $\alpha_3$ ) while keeping the coefficient on the lagged inflation ( $\alpha_1$ ) unchanged.<sup>27</sup>

## 4.2 Empirical Analysis on the Aggregate Inflation Dynamics

This section investigates the empirical relevance of imperfect information, encapsulated by the change in the ratio of the volatility of the sector-specific component to the aggregate component of demand ( $\tau_t/\sigma_t$ ), for the sensitivity of aggregate inflation ( $\pi_t$ ) to total demand. To this end, we first estimate the ratio of the volatility in Japan using principal component analysis. We then test the empirical relevance of the increases in the relative volatility of sector-specific shocks for the reduced sensitivity of aggregate inflation to changes in aggregate demand.

**Estimation of  $\tau_t/\sigma_t$ .** To estimate the ratio  $\tau_t/\sigma_t$ , we derive the variances for the changes in the aggregate and sector-specific components of demand ( $\sigma_t^2$  and  $\tau_t^2$ , respectively). We proxy changes in aggregate demand by the principal component of the movements in sales growth across sectors, following the approach in Boivin et al. (2009). We use quarterly data on sector-level sales of Japanese firms from the Financial Statements Statistics of Corporations by Industry, compiled by the Ministry of Finance of Japan. The data cover the period 1975:Q3-2022:Q4 for 29 major sectors in the economy.<sup>28</sup>

We proxy the changes in the aggregate component of demand with sales,  $u_t$ , by the first principal component of  $\tilde{x}_t(i)$  across sectors,  $i \in \{1, 2, \dots, 29\}$ , by calculating it as  $u_t = (\sum_{i=1}^{29} \Lambda_i)^{-1} \sum_{i=1}^{29} \Lambda_i \tilde{x}_t(i)$ , where  $\Lambda_i$  is the loading factor of  $\tilde{x}_t(i)$  and the term  $(\sum_{i=1}^{29} \Lambda_i)^{-1}$  normalizes  $\sum_{i=1}^{29} \tilde{x}_t(i)$ .<sup>29</sup> We proxy sector-specific demand,  $\tilde{v}_t(i)$ , by subtracting the esti-

<sup>27</sup>Appendix K.1 shows the impulse response function of the inflation to aggregate demand.

<sup>28</sup>Appendix G provides a description of the data.

<sup>29</sup>The proportion of the variance of the first component is around 20%, which is considerably larger than the variance of the second component (6%), suggesting that the second principal component plays a limited role in aggregate shocks. Note that since the principal component is  $\sum_{i=1}^{29} \Lambda_i \tilde{x}_t(i)$  and changes in sectoral

mated principal component from changes in total sectoral demand:<sup>30</sup>  $\tilde{x}_t(i) - u_t = \tilde{x}_t(i) - (\sum_{i=1}^{29} \Lambda_i)^{-1} \sum_{i=1}^{29} \Lambda_i \tilde{x}_t(i)$ .<sup>31</sup>

We proxy the variance of aggregate fluctuations,  $\sigma_t^2$ , with the average of the square of residuals of equation (4) for alternative moving windows of size  $2k + 1$ :

$$\sigma_t^2 = \frac{1}{2k + 1} \sum_{s=-k}^k \hat{e}_{t-s}^2. \quad (35)$$

To ensure the results are robust across the different time windows, we compute the variance of each shock in equations (35) and (36), using four alternative time windows: two quarters ( $k = 1$ ), four quarters ( $k = 2$ ), and eight quarters ( $k = 4$ ).

Similarly, we proxy the variance of the sector-specific fluctuations,  $\tau_t^2$ , with the average of the square of the averages of the residuals of (5) across sectors for alternative moving windows of size  $2k + 1$ :

$$\tau_t^2 = \frac{1}{2k + 1} \sum_{s=-k}^k \left( \frac{1}{29} \sum_{i=1}^{29} \frac{(\hat{\epsilon}_{t-s}(i) - \hat{\epsilon}_{t-s-1}(i))^2}{2} \right), \quad (36)$$

where  $k = 1, 2, 4$ .

Finally, we measure shock heterogeneity as the ratio of the square root of the estimate of the variance of sector-specific shocks ( $\tau_t$ ) to that of aggregate shocks ( $\sigma_t$ ).

Figure 2 shows the estimated series for the ratio of the standard deviation of sector-specific shocks to that of aggregate shocks ( $\tau_t/\sigma_t$ ) for the alternative time windows. Entries show that the ratio  $\tau_t/\sigma_t$  substantially varies throughout the sample period. The shorter the time window, the larger the volatility, but the overall dynamics of the changes are similar across the alternative estimates. Overall, the analysis establishes substantial changes in the  $\tau_t/\sigma_t$  ratio during the sample period.<sup>32</sup> Moreover, shock heterogeneity appears to have increased particularly during the 2000s and 2010s.

demand are  $\tilde{x}_t(i)$ , the scale of the principal component  $\sum_{i=1}^{29} \Lambda_i$  may differ from the scale of changes in sectoral demand. Estimation results reveal that  $\sum_{i=1}^{29} \Lambda_i \approx 4.7$ , which we use to normalize the principal component.

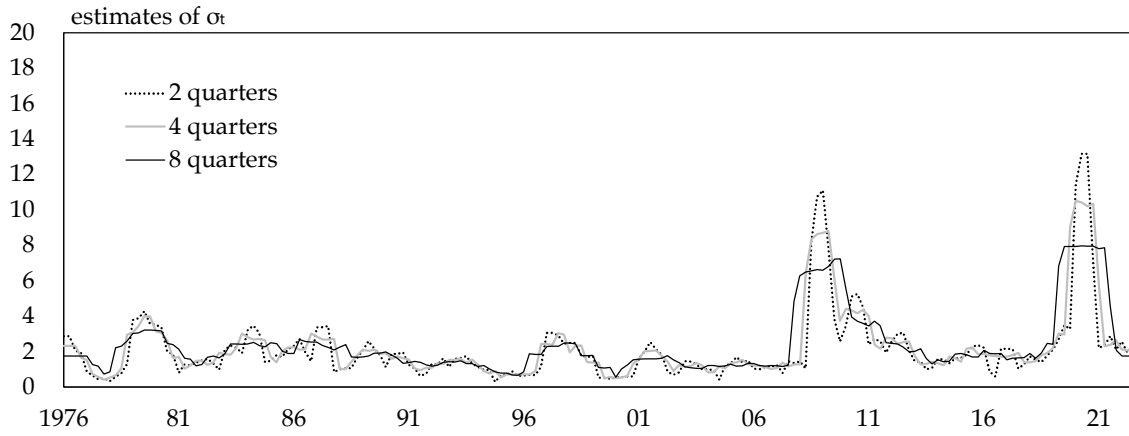
<sup>30</sup>To ensure results are robust to alternative normalization, we implement alternative specifications. First, we define  $u_t = \sum_{i=1}^{29} \Lambda_i \tilde{x}_t(i)$  and  $\tilde{x}_t(i) - u_t$ , and second, we define  $u_t = (\sum_{i=1}^{29} \Lambda_i)^{-1} \sum_{i=1}^{29} \Lambda_i \tilde{x}_t(i)$  and  $\tilde{x}_t(i) - u_t$ . Results remain unchanged across different normalization assumptions.

<sup>31</sup>Appendix H discusses the methodology we use to extract the sequence of shocks on aggregate and sector-specific components of total sectoral demand, and it provides summary statistics on the volatility of aggregate and sector-specific demand shocks. Appendix I shows that the changes in the series for aggregate demand extracted from the industry-level data are representative of aggregate movements in demand. Our series closely co-move with the average of industry-level data and with the measure of the output gap from the Bank of Japan that several studies use as a proxy for changes in aggregate demand.

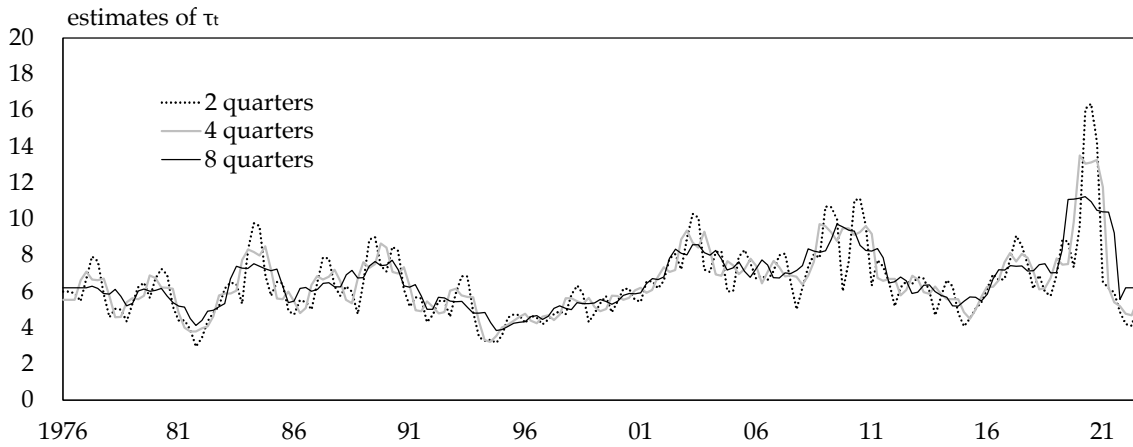
<sup>32</sup>Movements in  $\tau_t/\sigma_t$  are primarily driven by changes in the volatility of sector-specific demand shocks ( $\tau_t$ ) while the volatility of aggregate demand shock ( $\sigma_t$ ) remains broadly stable across the sample period, except during the period of the global financial crisis (2007:4Q to 2010:1Q).

Figure 2: Estimated shock heterogeneity ( $\tau_t/\sigma_t$ )

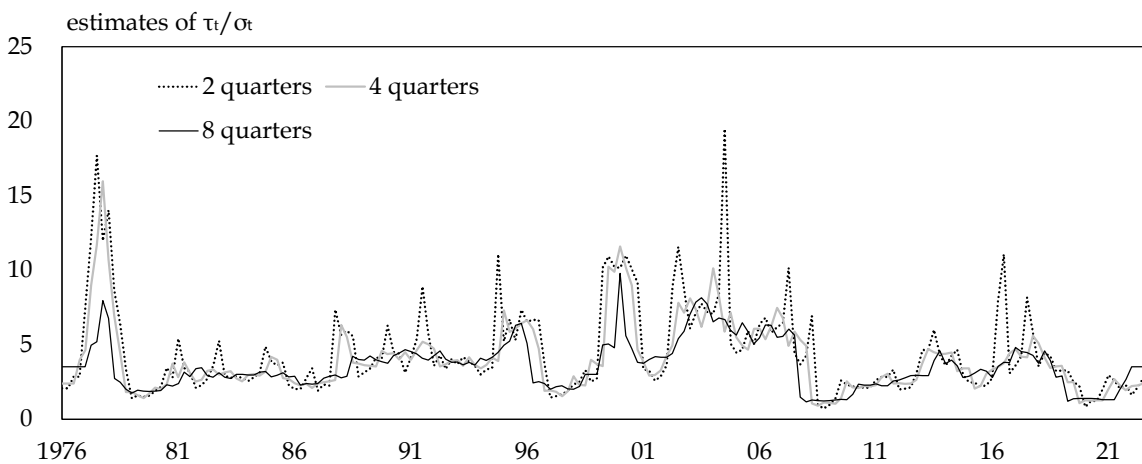
**(a) Standard deviation of aggregate shocks**



**(b) Standard deviation of sector-specific shocks**



**(c) Shock heterogeneity**



Source: Ministry of Finance "Financial statements statistics of corporations by industry".

**Sensitivity of Inflation to Changes in Aggregate Demand.** Using the estimated volatility ratio ( $\tau_t/\sigma_t$ ), we study the empirical relevance of the demand shock heterogeneity to inflation under imperfect information. Specifically, we investigate how an increase (or decrease) in the ratio affect the reduced (increased) sensitivity of inflation to changes in aggregate demand.

We set up the empirical model using the insights from the price equation (30) that accounts for the effect of information frictions in the relation between inflation and aggregate demand. We regress current inflation ( $\pi_t$ ) on past inflation ( $\pi_{t-1}$ ),<sup>33</sup> changes in current aggregate demand ( $u_t$ ), an interaction term between past inflation and the volatility ratio between sector-specific and aggregate shocks ( $\pi_{t-1} \times \tau_t/\sigma_t$ ), and an interaction term between changes in current aggregate demand and the volatility ratio. The interaction terms  $\pi_{t-1} \times \tau_t/\sigma_t$  and  $u_t \times \tau_t/\sigma_t$  capture the differential effect of the volatility ratio  $\tau_t/\sigma_t$  for the effect of past inflation and aggregate demand on current inflation, respectively. In line with the theoretical model, we include aggregate demand with two lags and control for the degree of nominal price rigidities, motivated by the fact the comparative statics in the model described in section 4.1 show that the higher degree of nominal price rigidity increases the persistence of inflation and reduces the sensitivity of current inflation to changes in current aggregate demand. Specifically, we use an indicator variable equal to 1 for the period 2000–2022 ( $\mathbf{1}_{\{2000-2022\}}$ ) when nominal price rigidities slightly decreased (see evidence in Sudo et al., 2014 and Kurachi et al., 2016), and we enrich the estimation of the price equation with two additional interaction terms. The first term interacts the indicator variable for nominal price rigidities with past inflation ( $\pi_{t-1} \times \mathbf{1}_{\{2000-2022\}}$ ) to capture the interplay between the degree of nominal price rigidity and the effect of past inflation on current inflation. The second term interacts the indicator variable for nominal price rigidities with current aggregate demand ( $u_t \times \mathbf{1}_{\{2000-2022\}}$ ) to capture the interplay between nominal price rigidities and current aggregate demand. The empirical specification of the price inflation is summarized by the

---

<sup>33</sup>We use quarterly changes in core consumer price index (all items less fresh food) as a proxy for aggregate inflation. The results remain broadly robust if we employ core-core consumer price index (all items less fresh food and energy). The CPI is taken from the Japanese Statistics Bureau and available here <https://www.stat.go.jp/english/data/cpi/index.html>

following equation:

$$\pi_t = c_1 + \underbrace{(c_2 + c_3 \mathbf{1}_{\{2000-2022\}} + c_4 (\tau_t/\sigma_t))}_{\alpha_1} \pi_{t-1} + \underbrace{(c_5 + c_6 \mathbf{1}_{\{2000-2022\}} + c_7 (\tau_t/\sigma_t))}_{\alpha_2} u_t + c_8 u_{t-1} + c_9 u_{t-2} + \varepsilon_t^c, \quad (37)$$

where the coefficients  $c_1, \dots, c_9$  are regression coefficients, and  $\varepsilon_t^c$  is the error term.

Table 4: Estimation of inflation dynamics

| <i>Dataset: Financial statement statistics of corporations by industry, consumer price index; 29 sectors; 1976/2Q-2022/4Q</i> |                              |                              |                             |
|-------------------------------------------------------------------------------------------------------------------------------|------------------------------|------------------------------|-----------------------------|
| <i>Dependent Variable: Inflation rate (<math>\pi_t</math>, core consumer price index, seasonally adjusted, QoQ)</i>           |                              |                              |                             |
|                                                                                                                               | <i>(i) two quarters</i>      | <i>(ii) four quarters</i>    | <i>(iii) eight quarters</i> |
| <i>Constant</i>                                                                                                               | 0.07 **<br>(0.03)            | 0.06 **<br>(0.03)            | 0.04<br>(0.02)              |
| <i>Lag of inflation (<math>\pi_{t-1}</math>)</i>                                                                              | 0.67 ***<br>(0.11)           | 0.67 ***<br>(0.13)           | 0.62 ***<br>(0.18)          |
| <i>Lag of inflation × time dummy (2000-2022)<br/>(<math>\pi_{t-1} \times \mathbf{1}_{\{2000-2022\}}</math>)</i>               | -0.27<br>(0.20)              | -0.27<br>(0.21)              | -0.25<br>(0.21)             |
| <i>Lag of inflation<br/>× shock heterogeneity (<math>\pi_{t-1} \times \tau_t/\sigma_t</math>)</i>                             | 0.01<br>(0.01)               | 0.02<br>(0.01)               | 0.04<br>(0.04)              |
| <i>Changes in aggregate demand (<math>u_t</math>)</i>                                                                         | 0.09 ***<br>(0.03)           | 0.09 ***<br>(0.03)           | 0.09 ***<br>(0.03)          |
| <i>Changes in aggregate demand × time<br/>dummy (2000-2022) (<math>u_t \times \mathbf{1}_{\{2000-2022\}}</math>)</i>          | -0.03<br>(0.03)              | -0.03<br>(0.03)              | -0.03<br>(0.03)             |
| <b><i>Changes in aggregate demand<br/>× shock heterogeneity (<math>u_t \times \tau_t/\sigma_t</math>)</i></b>                 | <b>-0.02 ***<br/>(0.005)</b> | <b>-0.02 ***<br/>(0.005)</b> | <b>-0.02 **<br/>(0.007)</b> |
| <i>Observations</i>                                                                                                           | 188                          | 188                          | 188                         |
| <i>Adjusted-R<sup>2</sup></i>                                                                                                 | 0.74                         | 0.74                         | 0.74                        |

Note: Estimated by ordinary-least-squares. The standard errors are HAC estimators. First and second lags of changes in aggregate demand are included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity. The series for the core consumer price index is "all items, less fresh food (impact of consumption taxes are adjusted)".

\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.

Table 4 shows the estimates for equation (37), using the  $\tau_t/\sigma_t$  ratio based on time-windows of two quarters (column 1), four quarters (column 2), and eight quarters (column 3), respectively. All entries show that current inflation is positively correlated with past inflation and current demand, consistent with the theoretical prediction in equation (26). The estimation also shows that the coefficient for the interaction term of past inflation with the indicator variable ( $\pi_{t-1} \times \mathbf{1}_{\{2000-2022\}}$ ) is negative while non-significant and that for the interaction term of past inflation with shock heterogeneity is almost zero, indicating that the positive correlation between current inflation and past inflation might have decreased with a modest decline in nominal price rigidities, again in line with the predictions of our



model. The estimates for the interaction term of changes in demand with the indicator variable ( $u_t \times \mathbf{1}_{\{2000-2022\}}$ ) are insignificant for all proxies of the  $\tau_t/\sigma_t$  ratio. Important for our analysis, the interaction term between aggregate demand and the degree of shock heterogeneity ( $u_t \times \tau_t/\sigma_t$ ) is negative and significant, implying that a rise in the  $\tau_t/\sigma_t$  ratio reduces the positive correlation between inflation and aggregate demand, in accordance with the results of our analysis.

Figure 3: Shock heterogeneity and sensitivity of inflation to changes in aggregate demand

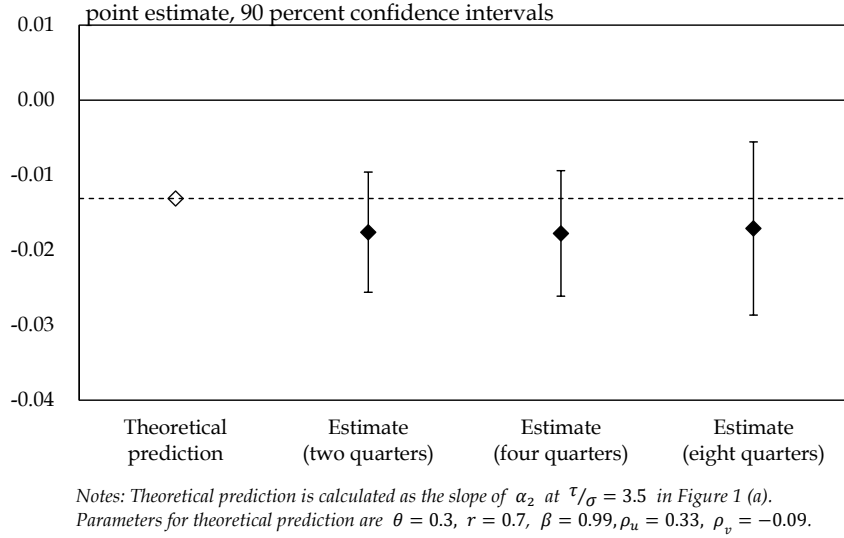


Figure 3 compares the estimates for the coefficient  $c_7$  on the interaction term ( $u_t \times \tau_t/\sigma_t$ ) for the alternative time windows of two, four, and eight quarters for the computation of the variance (dark diamond) against the coefficient  $\alpha_2$  on the interaction term  $u_t \times \tau_t/\sigma_t$  in equation (30), which represents the theoretical interaction between shock heterogeneity and aggregate demand (white diamond).<sup>34</sup> The bands around the central estimate in dark diamond represent 90 percent confidence intervals of the empirical estimates. The figure illustrates that the estimates derived from the data closely align with those generated by the theoretical model. This suggests that our theoretical framework is empirically consistent with the observed data.

Moreover, to ensure that the significance of the negative relation between  $\tau_t/\sigma_t$  and inflation is not driven by the inclusion of the 2000-2022 dummy variable, Table 5 presents results for the benchmark regression, omitting the indicator variable  $\mathbf{1}_{\{2000-2022\}}$  by omitting the in-

<sup>34</sup>The results are calculated as the changes in  $\alpha_2$  in accordance with changes in  $\tau_t/\sigma_t$  from 2.5 to 4.5, divided by the changes in  $\tau_t/\sigma_t$  (i.e.  $4.5-2.5=2$ ) under the same calibration of Figure 1.

Table 5: Estimation of inflation dynamics

| <i>Dataset: Financial statement statistics of corporations by industry, consumer price index; 29 sectors; 1976/2Q-2022/4Q</i> |                            |                            |                             |
|-------------------------------------------------------------------------------------------------------------------------------|----------------------------|----------------------------|-----------------------------|
| <i>Dependent Variable: Inflation rate (<math>\pi_t</math>, core consumer price index, seasonally adjusted, QoQ)</i>           |                            |                            |                             |
|                                                                                                                               | <i>(i) two quarters</i>    | <i>(ii) four quarters</i>  | <i>(iii) eight quarters</i> |
| <i>Constant</i>                                                                                                               | 0.08 ***<br>(0.02)         | 0.07 ***<br>(0.02)         | 0.05 **<br>(0.02)           |
| <i>Lag of inflation (<math>\pi_{t-1}</math>)</i>                                                                              | 0.69 ***<br>(0.11)         | 0.68 ***<br>(0.12)         | 0.62 ***<br>(0.19)          |
| <i>Lag of inflation</i><br><i>×shock heterogeneity (<math>\pi_{t-1} \times \tau_t/\sigma_t</math>)</i>                        | 0.01<br>(0.01)             | 0.02<br>(0.01)             | 0.04<br>(0.04)              |
| <i>Changes in aggregate demand (<math>u_t</math>)</i>                                                                         | 0.07 ***<br>(0.02)         | 0.07 ***<br>(0.02)         | 0.07 ***<br>(0.02)          |
| <b><i>Changes in aggregate demand</i></b><br><b><i>×shock heterogeneity (<math>u_t \times \tau_t/\sigma_t</math>)</i></b>     | <b>-0.02 ***</b><br>(0.01) | <b>-0.02 ***</b><br>(0.01) | <b>-0.02 *</b><br>(0.01)    |
| <i>Observations</i>                                                                                                           | 188                        | 188                        | 188                         |
| <i>Adjusted-R<sup>2</sup></i>                                                                                                 | 0.72                       | 0.72                       | 0.72                        |

Note: Estimated by ordinary-least-squares. The standard errors are HAC estimators. First and second lags of changes in aggregate demand are included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity. The series for the core consumer price index is “all items, less fresh food (impact of consumption taxes are adjusted)”.

\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.

teraction term between past inflation and the indicator variable (i.e.,  $\pi_{t-1} \times \mathbf{1}_{\{2000-2022\}}$ ) and the interaction term between changes in demand and the indicator variable ( $u_t \times \mathbf{1}_{\{2000-2022\}}$ ) from equation (37). The regression coefficient on the term  $u_t \times (\tau_t/\sigma_t)$  (bold entry) remains significant and negative, as in the benchmark regression.

Finally, to account for the possibility that firms set their prices flexibly, following equation (32), Table 6 presents the results for the benchmark regression (37) excluding the lagged inflation term  $\pi_{t-1}$ . The regression coefficient on the interaction term  $u_t \times (\tau_t/\sigma_t)$  (highlighted in bold) remains negative in all entries and statistically significant in (i) and (ii), consistent with the findings from the benchmark regression.

Our results suggest that the imperfect information on sectoral demand, together with the changes in shock heterogeneity, has significantly contributed to the time-variation in the sensitivity of inflation to the aggregate demand shock in Japan. Since shock heterogeneity increased in the late 1990s, the 2000s, and the 2010, our result is relevant for the flattening of the Phillips curve in Japan during the same period.<sup>35 36</sup> Appendix O shows that all results in this section remain broadly unchanged when we exclude the samples since the Covid-19

<sup>35</sup>See recent studies by Kaihatsu et al. (2023) and Bundick and Smith (2020).

<sup>36</sup>Appendix K.2 shows the estimated impulse response of inflation to aggregate demand.

Table 6: Estimation of inflation dynamics

| <i>Dataset: Financial statement statistics of corporations by industry, consumer price index; 29 sectors; 1976/2Q-2022/4Q</i> |                           |                           |                             |
|-------------------------------------------------------------------------------------------------------------------------------|---------------------------|---------------------------|-----------------------------|
| <i>Dependent Variable: Inflation rate (<math>\pi_t</math>, core consumer price index, seasonally adjusted, QoQ)</i>           |                           |                           |                             |
|                                                                                                                               | <i>(i) two quarters</i>   | <i>(ii) four quarters</i> | <i>(iii) eight quarters</i> |
| <i>Constant</i>                                                                                                               | 0.25 ***<br>(0.04)        | 0.23 ***<br>(0.04)        | 0.22 **<br>(0.04)           |
| <i>Changes in aggregate demand (<math>u_t</math>)</i>                                                                         | 0.08 ***<br>(0.02)        | 0.08 ***<br>(0.02)        | 0.07 ***<br>(0.02)          |
| <b><i>Changes in aggregate demand<br/>× shock heterogeneity (<math>u_t \times \tau_t / \sigma_t</math>)</i></b>               | <b>-0.02 **</b><br>(0.01) | <b>-0.02 **</b><br>(0.01) | <b>-0.01</b><br>(0.01)      |
| <i>Observations</i>                                                                                                           | 188                       | 188                       | 188                         |
| <i>Adjusted-R<sup>2</sup></i>                                                                                                 | 0.28                      | 0.28                      | 0.27                        |

*Note: Estimated by ordinary-least-squares. The standard errors are HAC estimators. First and second lags of changes in aggregate demand are included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity. The series for the core consumer price index is “all items, less fresh food (impact of consumption taxes are adjusted)”.*

*\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.*

pandemic. Appendix N further examines the validity of our theoretical framework using data on *sectoral* inflation.

## 5 Conclusion

Our study shows that imperfect information and shock heterogeneity are central to firms’ expectations and the sensitivity of inflation to real activity. Because firms cannot separately observe aggregate and sector-specific components of sectoral demand, price-setting behavior is affected by the composition of demand shocks. Using unique sector-level survey data covering the universe of Japanese firms, we document a positive co-movement between expectations of sector-specific and aggregate demand. We show that a simple model with imperfect information and both aggregate and sector-specific shocks replicates this empirical pattern. The model further predicts that greater volatility in sector-specific demand reduces the sensitivity of inflation to real activity, a prediction we corroborate using sector-level sales data for 29 Japanese sectors. Together with the observed increase in volatility in the 2000s and 2010s, the results imply that our framework can account for the flattening of the Phillips curve in Japan during the same period.

Our study opens important avenues for future research. A fundamental question left unanswered is the source of the reduction in the volatility of sector-specific shocks. Is the decline in the volatility of sector-specific demand resulting from improved production effi-

ciency or, alternatively, is it a by-product of smoother input-output linkages among firms? Both sources lead to a decrease in the variation of relative prices that is consistent with the recent decline in the volatility of sector-specific demand, but with a distinct impact on the propagation of shocks and different normative implications. Should monetary policy strategically communicate the economic outlook to exploit the effects of different demand components on firms' pricing decisions to achieve price stability? We plan to pursue some of these questions in future work.

## References

- Acharya, S. (2017). Costly Information, Planning Complementarities, and the Phillips Curve. *Journal of Money, Credit and Banking*, 49(4):823–850.
- Afrouzi, H. (2024). Strategic inattention, inflation dynamics, and the nonneutrality of money. *Journal of Political Economy*, 132(10):3378–3420.
- Afrouzi, H. and Yang, C. (2021). Dynamic Rational Inattention and the Phillips Curve. CESifo Working Paper Series 8840, CESifo.
- Akerlof, G., Dickens, W., and Perry, G. (1996). The Macroeconomics of Low Inflation. *Brookings Papers on Economic Activity*, 27(1):1–76.
- Alberro, J. (1981). The lucas hypothesis on the phillips curve: Further international evidence. *Journal of Monetary Economics*, 7(2):239–250.
- Andrade, P., Coibion, O., Gautier, E., and Gorodnichenko, Y. (2022). No firm is an island? how industry conditions shape firms' expectations. *Journal of Monetary Economics*, 125:40–56.
- Angeletos, G.-M. and La'O, J. (2009). Incomplete Information, Higher-Order Beliefs and Price Inertia. *Journal of Monetary Economics*, 56(S):19–37.
- Bai, X., Fernández-Villaverde, J., Li, Y., and Zanetti, F. (2026a). The causal effects of global supply chain disruptions on macroeconomic outcomes: Theory and evidence. *American Economic Review*. forthcoming.

- Bai, X., Fernández-Villaverde, J., Li, Y., and Zanetti, F. (2026b). State dependence of monetary policy during global supply chain disruptions. Working paper, University of Oxford.
- Ball, L. and Mankiw, N. G. (1995). Relative-Price Changes as Aggregate Supply Shocks. *The Quarterly Journal of Economics*, 110(1):161–193.
- Bartiloro, L., Bottone, M., and Rosolia, A. (2017). What does the heterogeneity of the inflation expectations of Italian firms tell us? *Questioni di Economia e Finanza (Occasional Papers)* 414, Bank of Italy, Economic Research and International Relations Area.
- Boivin, J., Giannoni, M., and Mihov, I. (2009). Sticky Prices and Monetary Policy: Evidence from Disaggregated US Data. *American Economic Review*, 99(1):350–84.
- Bundick, B. and Smith, A. L. (2020). Did the Federal Reserve Break the Phillips Curve? Theory and Evidence of Anchoring Inflation Expectations. Research Working Paper RWP 20-11, Federal Reserve Bank of Kansas City.
- Cacciatore, M. and Fiori, G. (2016). The Macroeconomic Effects of Goods and Labor Market Deregulation. *Review of Economic Dynamics*, 20:1–24.
- Calvo, G. (1983). Staggered Prices in a Utility-Maximizing Framework. *Journal of Monetary Economics*, 12(3):383–398.
- Chahrour, R., Chugh, S. K., Shapiro, A. F., and Lariau, A. (2016). The labor wedge: A search and matching perspective. Technical report, Boston College.
- Chahrour, R. and Ulbricht, R. (2019). Robust Predictions for DSGE Models with Incomplete Information. Boston College Working Paper Series, Boston College.
- Coibion, O. and Gorodnichenko, Y. (2015). Is the Phillips Curve Alive and Well after All? Inflation Expectations and the Missing Disinflation. *American Economic Journal: Macroeconomics*, 7(1):197–232.
- Coibion, O., Gorodnichenko, Y., and Kamdar, R. (2018). The Formation of Expectations, Inflation, and the Phillips Curve. *Journal of Economic Literature*, 56(4):1447–91.

- Coibion, O., Gorodnichenko, Y., Kumar, S., and Ryngaert, J. (2021). Do You Know That I Know That You Know...? Higher-Order Beliefs in Survey Data. *The Quarterly Journal of Economics*, 136(3):1387–1446.
- Coibion, O., Gorodnichenko, Y., and Ropele, T. (2020). Inflation Expectations and Firm Decisions: New Causal Evidence. *The Quarterly Journal of Economics*, 135(1):165–219.
- Crucini, M. J., Shintani, M., and Tsuruga, T. (2015). Noisy Information, Distance and Law of One Price Dynamics across US Cities. *Journal of Monetary Economics*, 74(C):52–66.
- di Giovanni, J., Levchenko, A. A., and Mejean, I. (2014). Firms, Destinations, and Aggregate Fluctuations. *Econometrica*, 82(4):1303–1340.
- Dupor, B., Kitamura, T., and Tsuruga, T. (2010). Integrating Sticky Prices and Sticky Information. *The Review of Economics and Statistics*, 92(3):657–669.
- Faccini, R., Millard, S., and Zanetti, F. (2013). Wage rigidities in an estimated dynamic, stochastic, general equilibrium model of the uk labour market. *The Manchester School*, 81(5):66–99.
- Fernández-Villaverde, J., Mandelman, F., Yu, Y., and Zanetti, F. (2021). The “Matthew Effect” and market concentration: Search complementarities and monopsony power. *Journal of Monetary Economics*, 121:62–90.
- Fernández-Villaverde, J., Mandelman, F., Yu, Y., and Zanetti, F. (2025). Search complementarities, aggregate fluctuations, and fiscal policy. *Review of Economic Studies*, 92(4):2502–2536.
- Fernández-Villaverde, J., Yu, Y., and Zanetti, F. (2024). Technological synergies, heterogeneous firms, and uncertainty shocks. NBER Working Paper 32247, National Bureau of Economic Research.
- Fukunaga, I. (2007). Imperfect Common Knowledge, Staggered Price Setting, and the Effects of Monetary Policy. *Journal of Money, Credit and Banking*, 39(7):1711–1739.
- Gáti, L. (2023). Monetary policy & anchored expectations—an endogenous gain learning model. *Journal of Monetary Economics*, 140:S37–S47.

- Guerron-Quintana, P., Fernandez-Villaverde, J., and Drautzburg, T. (2018). Filtering with Incomplete Information. Technical report, University of Pennsylvania, Federal Reserve Bank of Philadelphia, Boston College.
- Hellwig, C. and Venkateswaran, V. (2009). Setting the Right Prices for the Wrong Reasons. *Journal of Monetary Economics*, 56(S):57–77.
- Hellwig, C. and Venkateswaran, V. (2024). Dispersed information, nominal rigidities and monetary business cycles: A hayekian perspective. Working Paper 33215, National Bureau of Economic Research.
- Holm, M. B., Lerdalen, L. O., and Vines, D. (2024). The effect of capacity constraints on the slope of the phillips curve. *Oxford Economic Papers*, 76(4):1226–1238.
- Kaihatsu, S., Katagiri, M., and Shiraki, N. (2023). Phillips correlation and price-change distributions under declining trend inflation. *Journal of Money, Credit and Banking*, 55(5):1271–1305.
- Kato, R. and Okuda, T. (2017). Market Concentration and Sectoral Inflation under Imperfect Common Knowledge. IMES Discussion Paper Series 17-E-11, Institute for Monetary and Economic Studies, Bank of Japan.
- Kato, R., Okuda, T., and Tsuruga, T. (2021). Sectoral inflation persistence, market concentration, and imperfect common knowledge. *Journal of Economic Behavior & Organization*, 192:500–517.
- Kawamoto, T., Nakajima, J., and Mikami, T. (2025). Inflation-overshooting commitment: an analysis using a macroeconomic model. *Oxford Economic Papers*, 77(1):213–233.
- Kumar, S., Afrouzi, H., Coibion, O., and Gorodnichenko, Y. (2015). Inflation Targeting Does Not Anchor Inflation Expectations: Evidence from Firms in New Zealand. *Brookings Papers on Economic Activity*, 46(2 (Fall)):151–225.
- Kurachi, Y., Hiraki, K., and Nishioka, S. (2016). Does a Higher Frequency of Micro-level Price Changes Matter for Macro Price Stickiness?: Assessing the Impact of Temporary Price Changes. Bank of Japan Working Paper Series 16-E-9, Bank of Japan.

- L'Huillier, J.-P. (2020). Consumers' Imperfect Information and Endogenous Price Rigidities. *American Economic Journal: Macroeconomics*, 12(2):94–123.
- L'Huillier, J.-P., Singh, S. R., and Yoo, D. (2023). Incorporating diagnostic expectations into the new keynesian framework. *The Review of Economic Studies*, 91(5):3013–3046.
- L'Huillier, J.-P. and Zame, William, R. (2020). The Flattening of the Phillips Curve and the Learning Problem of the Central Bank. Working Paper Series , Brandeis University.
- Li, Z., Xu, Z., and Zanetti, F. (2026). Monetary policy in a data economy. Working paper, University of Oxford.
- Lucas, R. (1972). Expectations and the Neutrality of Money. *Journal of Economic Theory*, 4(2):103–124.
- Lucas, R. (1973). Some International Evidence on Output-Inflation Tradeoffs. *American Economic Review*, 63(3):326–334.
- Mackowiak, B., Moench, E., and Wiederholt, M. (2009a). Sectoral Price Data and Models of Price Setting. *Journal of Monetary Economics*, 56(S):78–99.
- Mackowiak, B., Moench, E., and Wiederholt, M. (2009b). Sectoral price data and models of price setting. *Journal of Monetary Economics*, 56(S):S78–S99.
- Mackowiak, B. and Wiederholt, M. (2009). Optimal Sticky Prices under Rational Inattention. *American Economic Review*, 99(3):769–803.
- Mankiw, G. and Reis, R. (2002). Sticky Information versus Sticky Prices: A Proposal to Replace the New Keynesian Phillips Curve. *The Quarterly Journal of Economics*, 117(4):1295–1328.
- Mavroeidis, S., Plagborg-Moller, M., and Stock, J. (2014). Empirical Evidence on Inflation Expectations in the New Keynesian Phillips Curve. *Journal of Economic Literature*, 52(1):124–88.
- Melosi, L. (2017). Signalling Effects of Monetary Policy. *Review of Economic Studies*, 84(2):853–884.



- Melosi, L., Morita, H., Picco, A. R., and Zanetti, F. (2024). The signaling effects of fiscal announcements. Discussion Paper 19380, CEPR.
- Mitra, A. (2025). Imperfect information and slow recoveries in the labor market. Technical report, Board of Governors of the Federal Reserve System.
- Nimark, K. (2008). Dynamic Pricing and Imperfect Common Knowledge. *Journal of Monetary Economics*, 55(2):365–382.
- Okuda, T. and Tsuruga, T. (2025). Sectoral inflation under fragmentation of information. *Macroeconomic Dynamics*, 29:e69.
- Pizzinelli, C., Theodoridis, K., and Zanetti, F. (2020). State dependence in labor market fluctuations. *International Economic Review*, 61(3):1027–1072.
- Qiu, Z., Wang, Y., Xu, L., and Zanetti, F. (2026). Monetary policy in open economies with production networks. *Journal of Monetary Economics*, forthcoming.
- Rafiq, M. S. and Mallick, S. K. (2008). The effect of monetary policy on output in emu3: A sign restriction approach. *Journal of Macroeconomics*, 30(4):1756–1791.
- Roberts, J. (2004). Monetary Policy and Inflation Dynamics. Finance and Economics Discussion Series 2004-62, Board of Governors of the Federal Reserve System (U.S.).
- Sbordone, A. (2008). Globalization and Inflation Dynamics: the Impact of Increased Competition. Staff Reports 324, Federal Reserve Bank of New York.
- Sudo, N., Ueda, K., and Watanabe, K. (2014). Micro Price Dynamics under Japan’s Lost Decades. *Asian Economic Policy Review*, 9(1):44–64.
- Thomas, C. and Zanetti, F. (2009). Labor Market Reform and Price Stability: An Application to the Euro Area. *Journal of Monetary Economics*, 56(6):885–899.
- Veldkamp, L. and Wolfers, J. (2007). Aggregate Shocks or Aggregate Information? Costly Information and Business Cycle Comovement. *Journal of Monetary Economics*, 54:37–55.
- Woodford, M. (2003). Imperfect Common Knowledge and the Effects of Monetary Policy. in P. Aghion, R. Frydman, J. Stiglitz, and M. Woodford, eds., knowledge, information,

and expectations in modern macroeconomics: In honour of Edmund S. Phelps, Princeton: Princeton University Press.

Xu, L., Yu, Y., and Zanetti, F. (2025). The adoption and termination of suppliers over the business cycle. *Journal of Monetary Economics*, 151:103730.

Zanetti, F. (2007). A non-walrasian labor market in a monetary model of the business cycle. *Journal of Economic Dynamics and Control*, 31(7):2413–2437.

Zanetti, F. (2009). Effects of Product and Labor Market Regulation on Macroeconomic Outcomes. *Journal of Macroeconomics*, 31(2):320–332.

Zanetti, F. (2011). Labor Market Institutions and Aggregate Fluctuations in a Search and Matching Model. *European Economic Review*, 55(5):644–658.

## A Derivation of Demand Functions and Price Indexes

### A.1 Demand Functions

The representative household first determines the allocation of consumption across sectors and then determines that to goods in each sector taking the expenditure level to each sector as given.

Define the expenditure level by  $Z_t \equiv \int_0^1 P_t(i)C_t(i)di$ , the Lagrangian is:

$$L = \left[ \int_0^1 (C_t(i)\Theta_t(i))^{\frac{\eta-1}{\eta}} di \right]^{\frac{\eta}{\eta-1}} - \lambda_t \left( \int_0^1 P_t(i)C_t(i)di - Z_t \right), \quad (\text{A.1})$$

and the first-order conditions are:

$$C_t(i)^{-\frac{1}{\eta}} C_t^{\frac{1}{\eta}} (\Theta_t(i))^{\frac{\eta-1}{\eta}} = \lambda_t P_t(i). \quad (\text{A.2})$$

Thus, for any two sectors, the following equation holds:

$$C_t(i) = C_t(j) \left( \frac{P_t(i)}{P_t(j)} \right)^{-\eta} \left( \frac{\Theta_t(i)}{\Theta_t(j)} \right)^{\eta-1}. \quad (\text{A.3})$$

By substituting equations (A.2) and (A.3) into the definition of consumption expenditures ( $Z_t \equiv \int_0^1 P_t(i)C_t(i)di$ ), it yields:

$$\begin{aligned} \int_0^1 P_t(i) \left[ C_t(j) \left( \frac{P_t(i)}{P_t(j)} \right)^{-\eta} \left( \frac{\Theta_t(i)}{\Theta_t(j)} \right)^{\eta-1} \right] di &= Z_t \\ \Leftrightarrow C_t(j) &= P_t^{-\eta}(j) \Theta_t^{\eta-1}(j) Z_t \frac{1}{\int_0^1 P_t^{1-\eta}(i) \Theta_t^{\eta-1}(i) di}. \end{aligned} \quad (\text{A.4})$$

By substituting the equation:

$$\int_0^1 P_t(i)C_t(i)di = Z_t = P_t C_t,$$

into equation (A.4), it yields:

$$C_t(i) = \Theta_t^{\eta-1}(i) \left( \frac{P_t(i)}{P_t} \right)^{-\eta} C_t \frac{P_t^{1-\eta}}{\int_0^1 P_t^{1-\eta}(i) \Theta_t^{\eta-1}(i) di}. \quad (\text{A.5})$$

Using the definition of the price level,  $P_t \equiv \left[ \int_0^1 P_t^{1-\eta}(i) \Theta_t^{\eta-1}(i) di \right]^{\frac{1}{1-\eta}}$ , we can re-write equation (A.5) as:

$$C_t(i) = \Theta_t^{\eta-1}(i) \left( \frac{P_t(i)}{P_t} \right)^{-\eta} C_t. \quad (\text{A.6})$$

Applying the same calculation for  $C_t(i) = \left[ \int_0^1 (C_t(i, j))^{\frac{\tilde{\eta}-1}{\tilde{\eta}}} dj \right]^{\frac{\tilde{\eta}}{\tilde{\eta}-1}}$ , it yields:

$$C_t(i, j) = \left( \frac{P_t(i, j)}{P_t(i)} \right)^{-\tilde{\eta}} C_t(i). \quad (\text{A.7})$$

By combining equations (A.6) and (A.7), we obtain the demand for good  $(i, j)$  as follows:

$$C_t(i, j) = \Theta_t^{\eta-1}(i) \left( \frac{P_t(i, j)}{P_t(i)} \right)^{-\tilde{\eta}} \left( \frac{P_t(i)}{P_t} \right)^{-\eta} C_t.$$

## A.2 Price Indexes

We show the derivation of aggregate price index  $P_t \equiv \left[ \int_0^1 P_t^{1-\eta}(i) \Theta_t^{\eta-1}(i) di \right]^{\frac{1}{1-\eta}}$ , and we omit the derivation of sectoral price index  $P_t(i) \equiv \left[ \int_0^1 P_t^{1-\tilde{\eta}}(i, j) dj \right]^{\frac{1}{1-\tilde{\eta}}}$  since it can be similarly derived.

Recall that  $\lambda_t^{-1}$  indicates the shadow price of one unit of utility. The first-order condition in equation (A.2) can be re-written as:

$$\begin{aligned} & C_t(i)^{-\frac{1}{\eta}} C_t^{\frac{1}{\eta}} (\Theta_t(i))^{\frac{\eta-1}{\eta}} = \lambda_t P_t(i) \\ \Leftrightarrow & C_t(i)^{\frac{\eta-1}{\eta}} C_t^{\frac{1}{\eta}} (\Theta_t(i))^{\frac{\eta-1}{\eta}} = \lambda_t C_t(i) P_t(i) \\ \Leftrightarrow & \int_0^1 \left( C_t(i)^{\frac{\eta-1}{\eta}} (\Theta_t(i))^{\frac{\eta-1}{\eta}} \right) di C_t^{\frac{1}{\eta}} = \lambda_t \int_0^1 C_t(i) P_t(i) di \\ \Leftrightarrow & C_t \lambda_t^{-1} = Z. \end{aligned}$$

From the first-order condition (A.2) we derive the aggregate price index:

$$\begin{aligned} & C_t(i)^{-\frac{1}{\eta}} C_t^{\frac{1}{\eta}} (\Theta_t(i))^{\frac{\eta-1}{\eta}} = \lambda_t P_t(i) \\ \Leftrightarrow & (C_t(i) \Theta_t(i))^{-\frac{1}{\eta}} C_t^{\frac{1}{\eta}} \Theta_t(i) = \lambda_t P_t(i) \\ \Leftrightarrow & (C_t(i) \Theta_t(i))^{\frac{1}{\eta}} = C_t^{\frac{1}{\eta}} \Theta_t(i) \lambda_t^{-1} P_t^{-1}(i) \\ \Leftrightarrow & (C_t(i) \Theta_t(i))^{\frac{\eta-1}{\eta}} = C_t^{\frac{\eta-1}{\eta}} \Theta_t^{\eta-1}(i) \lambda_t^{1-\eta} P_t^{1-\eta}(i) \\ \Leftrightarrow & \int_0^1 (C_t(i) \Theta_t(i))^{\frac{\eta-1}{\eta}} di = C_t^{\frac{\eta-1}{\eta}} \lambda_t^{1-\eta} \int_0^1 (P_t^{1-\eta}(i) \Theta_t^{\eta-1}(i)) di \\ \Leftrightarrow & 1 = \lambda_t^{1-\eta} \int_0^1 (P_t^{1-\eta}(i) \Theta_t^{\eta-1}(i)) di \\ \Leftrightarrow & \lambda_t^{-1} = \left[ \int_0^1 (P_t^{1-\eta}(i) \Theta_t^{\eta-1}(i)) di \right]^{\frac{1}{1-\eta}}. \end{aligned}$$

## B Derivation of the Index of Aggregate Prices

Recall that:  $P_t \equiv \left[ \int_0^1 P_t^{1-\eta}(i) \Theta_t^{\eta-1}(i) di \right]^{\frac{1}{1-\eta}}$  can be expressed as,  $P_t = \left[ \int_0^1 \left( \frac{P_t(i)}{\Theta_t(i)} \right)^{1-\eta} di \right]^{\frac{1}{1-\eta}} = \left[ \int_0^1 \left( \tilde{P}_t(i) \right)^{1-\eta} di \right]^{\frac{1}{1-\eta}}$ , where  $\tilde{P}_t(i) \equiv \frac{P_t(i)}{\Theta_t(i)}$ . We then define  $p_t \equiv \int_0^1 \tilde{p}_t(i) di$ , such that:

$$p_t \equiv \int_0^1 \tilde{p}_t(i) di = \int_0^1 p_t(i) di - \int_0^1 \zeta_t(i) di = \int_0^1 p_t(i) di,$$

since  $\zeta_t(i) \sim \mathcal{N}(0, (1-\epsilon)^{-2} (\eta-1)^{-2} \tau_t^2)$  and  $\int_0^1 \zeta_t(i) di = 0$ .

## C Derivation of the Price Setting Rule

Using the following equations:

$$p_t(i, j) = \mu + mc_t(i, j),$$

$$c_t(i, j) = -\tilde{\eta} (p_t(i, j) - p_t(i)) - \eta (p_t(i) - p_t) + c_t + (\eta - 1) \zeta_t(i),$$

and

$$mc_t(i, j) = w_t + \frac{1-\epsilon}{\epsilon} y_t(i, j) - \frac{1}{\epsilon} a - \log(\epsilon),$$

the price of firm  $j$  in sector  $i$ ,  $p_t(i, j)$ , is equal to:

$$\begin{aligned}
p_t(i, j) &= \mu + mc_t(i, j) = \mu + y_t + p_t - \frac{1}{\epsilon}a - \log(\epsilon) \\
&\quad + \frac{1-\epsilon}{\epsilon} [-\tilde{\eta} (p_t(i, j) - p_t(i)) - \eta (p_t(i) - p_t) + c_t + (\eta - 1) \zeta_t(i)] \\
&= -\frac{1-\epsilon}{\epsilon} \tilde{\eta} p_t(i, j) + \frac{1-\epsilon}{\epsilon} (\tilde{\eta} - \eta) p_t(i) + \left(1 + \frac{1-\epsilon}{\epsilon} \eta\right) p_t \\
&\quad + \left(\mu - \frac{1}{\epsilon}a - \log(\epsilon)\right) + \left(1 + \frac{1-\epsilon}{\epsilon}\right) y_t + \frac{1-\epsilon}{\epsilon} (\eta - 1) \zeta_t(i) \\
&= -\frac{1-\epsilon}{\epsilon} \tilde{\eta} p_t(i, j) + \frac{1-\epsilon}{\epsilon} (\tilde{\eta} - \eta) p_t(i) + \left(\mu - \frac{1}{\epsilon}a - \log(\epsilon)\right) \\
&\quad + \left(1 + \frac{1-\epsilon}{\epsilon}\right) q_t + \frac{1-\epsilon}{\epsilon} (\eta - 1) p_t + \frac{1-\epsilon}{\epsilon} (\eta - 1) \zeta_t(i) \\
&= \frac{\frac{1-\epsilon}{\epsilon} (\tilde{\eta} - \eta)}{1 + \frac{1-\epsilon}{\epsilon} \tilde{\eta}} p_t(i) + \frac{1}{1 + \frac{1-\epsilon}{\epsilon} \tilde{\eta}} \left(\mu - \frac{1}{\epsilon}a - \log(\epsilon)\right) \\
&\quad + \frac{1 + \frac{1-\epsilon}{\epsilon}}{1 + \frac{1-\epsilon}{\epsilon} \tilde{\eta}} q_t + \frac{\frac{1-\epsilon}{\epsilon} (\eta - 1)}{1 + \frac{1-\epsilon}{\epsilon} \tilde{\eta}} p_t + \frac{\frac{1-\epsilon}{\epsilon} (\eta - 1)}{1 + \frac{1-\epsilon}{\epsilon} \tilde{\eta}} \zeta_t(i) \\
&= \frac{(\tilde{\eta} - \eta) (1 - \epsilon)}{\epsilon + \tilde{\eta} (1 - \epsilon)} p_t(i) + \frac{\epsilon}{\epsilon + \tilde{\eta} (1 - \epsilon)} \left(\mu - \frac{1}{\epsilon}a - \log(\epsilon)\right) \\
&\quad + \frac{1}{\epsilon + \tilde{\eta} (1 - \epsilon)} q_t + \frac{(1 - \epsilon) (\eta - 1)}{\epsilon + \tilde{\eta} (1 - \epsilon)} p_t + \frac{(1 - \epsilon) (\eta - 1)}{\epsilon + \tilde{\eta} (1 - \epsilon)} \zeta_t(i).
\end{aligned}$$

## D Proofs of Propositions

### D.1 Proof of Proposition 1

The terms  $\mathbb{E}_t[u_t]$  and  $\mathbb{E}_t[v_t(i)]$  are equal to:

$$\begin{aligned}
\mathbb{E}_t[u_t] &= \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} (q_{t-1} + \rho_u u_{t-1}) + \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} [x_t(i) - \rho_v v_{t-1}(i)] - q_{t-1} \\
&= \rho_u u_{t-1} + \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} [x_t(i) - q_{t-1} - \rho_u u_{t-1} - \rho_v v_{t-1}(i)] \\
&= \rho_u u_{t-1} + \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} [e_t + \epsilon_t(i)] \\
\mathbb{E}_t[v_t(i)] &= \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} \rho_v v_{t-1}(i) + \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} [x_t(i) - q_{t-1} - \rho_u u_{t-1}] \\
&= \rho_v v_{t-1}(i) + \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} [x_t(i) - q_{t-1} - \rho_u u_{t-1} - \rho_v v_{t-1}(i)] \\
&= \rho_v v_{t-1}(i) + \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} [e_t + \epsilon_t(i)]
\end{aligned}$$

Thus,  $\mathbb{E}_t [\tilde{v}_t]$  is given by,

$$\begin{aligned}\mathbb{E}_t [\tilde{v}_t(i)] &= \rho_v v_{t-1}(i) + \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} [e_t + \epsilon_t(i)] - v_{t-1}(i) \\ &= (\rho_v - 1)v_{t-1}(i) + \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} [e_t + \epsilon_t(i)]. \square\end{aligned}$$

## D.2 Proof of Proposition 2

From equations (8) and (9), we have the following.

$$\begin{aligned}\mathbb{C}(\mathbb{E}_t [u_t], \mathbb{E}_t [\tilde{v}_t] | \mathcal{F}_{t-1}) &= \mathbb{E} [\mathbb{E}_t [u_t] - \mathbb{E}[\mathbb{E}_t [u_t] | \mathcal{F}_{t-1}], \mathbb{E}_t [\tilde{v}_t] - \mathbb{E}[\mathbb{E}_t [\tilde{v}_t] | \mathcal{F}_{t-1}] | \mathcal{F}_{t-1}] \\ &= \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \mathbb{V}[e_t + \epsilon_t(i)] = \frac{\sigma_t^2 \tau_t^2}{\sigma_t^2 + \tau_t^2} > 0. \square\end{aligned}$$

## D.3 Proof of Proposition 3

Denote  $k$ -period ahead expectations by  $\mathbb{E}_t \left[ \sum_{h=1}^k u_{t+h} \right]$  and  $\mathbb{E}_t \left[ \sum_{h=1}^k \tilde{v}_{t+h}(i) \right]$ . The terms  $\mathbb{E}_t \left[ \sum_{h=1}^k u_{t+h} \right]$  and  $\mathbb{E}_t \left[ \sum_{h=1}^k \tilde{v}_{t+h}(i) \right]$  are then equal to:

$$\begin{aligned}\mathbb{E}_t \left[ \sum_{h=1}^k u_{t+h} \right] &= \frac{1 - \rho_u^{k+1}}{1 - \rho_u} \mathbb{E}_t [u_t], \\ \mathbb{E}_t \left[ \sum_{h=1}^k \tilde{v}_{t+h}(i) \right] &= \frac{1 - \rho_v^{k+1}}{1 - \rho_v} \mathbb{E}_t [\tilde{v}_t],\end{aligned}$$

respectively. It follows that:

$$\mathbb{C} \left( \mathbb{E}_t \left[ \sum_{h=1}^k u_{t+h} \right], \mathbb{E}_t \left[ \sum_{h=1}^k \tilde{v}_{t+h}(i) \right] | \mathcal{F}_{t-1} \right) = \frac{1 - \rho_u^{k+1}}{1 - \rho_u} \frac{1 - \rho_v^{k+1}}{1 - \rho_v} \mathbb{C}(\mathbb{E}_t [u_t], \mathbb{E}_t [\tilde{v}_t] | \mathcal{F}_{t-1}) > 0.$$

Plugging  $k = 4$  into this equation proves the proposition.  $\square$

## D.4 Proof of Proposition 4

First, we guess that  $p_t^*(i)$  takes the following form:

$$p_t^*(i) = a_1 p_{t-1} + a_2 x_t(i) + a_3 q_{t-1} + a_4 u_{t-1} + a_5 v_{t-1}(i).$$

Given the guess, and since only a randomly selected fraction  $1 - \theta$  of firms adjusts prices in any given period, we infer that the sectoral and aggregate price level must satisfy:

$$\begin{aligned}p_t(i) &= \theta p_{t-1}(i) + (1 - \theta) \int_0^1 p_t^*(i) di \\ &= [\theta + (1 - \theta) a_1] p_{t-1} + (1 - \theta) a_2 x_t(i) + (1 - \theta) a_3 q_{t-1} + (1 - \theta) a_4 u_{t-1} + a_5 v_{t-1}(i).\end{aligned}$$

$$\begin{aligned}
p_t &= \int_0^1 p_t(i) di \\
&= [\theta + (1 - \theta) a_1] p_{t-1} + (1 - \theta) a_2 q_t + (1 - \theta) a_3 q_{t-1} + (1 - \theta) a_4 u_{t-1}.
\end{aligned}$$

Therefore,  $p_t^*(i)$  is obtained as:

$$\begin{aligned}
p_t^*(i) &= (1 - \beta\theta) [(1 - r)x_t(i) + r\mathbb{E}_t[p_t]] + \beta\theta\mathbb{E}_t[p_{t+1}^*(i)] \\
&= (1 - \beta\theta)(1 - r)x_t(i) + (1 - \beta\theta)r\mathbb{E}_t[p_t] + \beta\theta\mathbb{E}_t[p_{t+1}^*(i)] \\
&= (1 - \beta\theta)(1 - r)x_t(i) + (1 - \beta\theta)r\mathbb{E}_t[p_t] \\
&\quad + \beta\theta\mathbb{E}_t[a_1 p_t + a_2 x_{t+1}(i) + a_3 q_t + a_4 u_t + a_5 v_t(i)] \\
&= (1 - \beta\theta)(1 - r)x_t(i) + [(1 - \beta\theta)r + \beta\theta a_1] \mathbb{E}_t[p_t] \\
&\quad + \beta\theta a_2 \mathbb{E}_t[x_{t+1}(i)] + \beta\theta a_3 \mathbb{E}_t[q_t] + \beta\theta a_4 \mathbb{E}_t[u_t] + \beta\theta a_5 \mathbb{E}_t[v_t(i)] \\
&= (1 - \beta\theta)(1 - r)x_t(i) + [(1 - \beta\theta)r + \beta\theta a_1] \mathbb{E}_t[p_t] \\
&\quad + \beta\theta a_2 \mathbb{E}_t[q_t + u_{t+1} + v_{t+1}(i)] + \beta\theta a_3 \mathbb{E}_t[q_t] + \beta\theta a_4 \mathbb{E}_t[u_t] + \beta\theta a_5 \mathbb{E}_t[v_t(i)] \\
&= (1 - \beta\theta)(1 - r)x_t(i) + [(1 - \beta\theta)r + \beta\theta a_1] \mathbb{E}_t[p_t] \\
&\quad + \beta\theta (a_2 + a_3) \mathbb{E}_t[q_t] + \beta\theta (a_2 \rho_u + a_4) \mathbb{E}_t[u_t] + \beta\theta (a_2 \rho_v + a_5) \mathbb{E}_t[v_t(i)].
\end{aligned}$$

The term  $\mathbb{E}_t[p_t]$  is given by:

$$\mathbb{E}_t[p_t] = [\theta + (1 - \theta) a_1] p_{t-1} + (1 - \theta) a_2 \mathbb{E}_t[q_t] + (1 - \theta) a_3 q_{t-1} + (1 - \theta) a_4 u_{t-1},$$



which yields:

$$\begin{aligned}
p_t^*(i) &= (1 - \beta\theta)(1 - r)x_t(i) + [(1 - \beta\theta)r + \beta\theta a_1] [\theta + (1 - \theta) a_1] p_{t-1} \\
&\quad + [[(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) a_2 + \beta\theta (a_2 + a_3)] \mathbb{E}_t [q_t] \\
&\quad + [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) a_3 q_{t-1} \\
&\quad + [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) a_4 u_{t-1} \\
&\quad + \beta\theta (a_2 \rho_u + a_4) \mathbb{E}_t [u_t] + \beta\theta (a_2 \rho_v + a_5) \mathbb{E}_t [v_t(i)] \\
&= (1 - \beta\theta)(1 - r)x_t(i) + [(1 - \beta\theta)r + \beta\theta a_1] [\theta + (1 - \theta) a_1] p_{t-1} \\
&\quad + [([(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) a_2 + \beta\theta (a_2 + a_3)) + [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) a_3] q_{t-1} \\
&\quad + [([(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) a_2 + \beta\theta (a_2 + a_3)) + \beta\theta (a_2 \rho_u + a_4)] \mathbb{E}_t [u_t] \\
&\quad + \beta\theta (a_2 \rho_v + a_5) \mathbb{E}_t [v_t(i)] \\
&\quad + [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) a_4 u_{t-1} \\
&= (1 - \beta\theta)(1 - r)x_t(i) + [(1 - \beta\theta)r + \beta\theta a_1] [\theta + (1 - \theta) a_1] p_{t-1} \\
&\quad + b_1 q_{t-1} + b_2 \mathbb{E}_t [u_t] + b_3 \mathbb{E}_t [v_t(i)] + b_4 u_{t-1}.
\end{aligned}$$

where

$$\begin{aligned}
b_1 &= [[(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) a_2 + \beta\theta (a_2 + a_3)] + [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) a_3, \\
b_2 &= [[(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) a_2 + \beta\theta (a_2 + a_3)] + \beta\theta (a_2 \rho_u + a_4), \\
b_3 &= \beta\theta (a_2 \rho_v + a_5), \\
b_4 &= [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) a_4.
\end{aligned}$$

Since

$$\begin{aligned}
x_t(i) &= q_{t-1} + \rho_u u_{t-1} + e_t + \rho_v v_{t-1}(i) + \epsilon_t(i) \\
&\Leftrightarrow e_t = x_t(i) - q_{t-1} - \rho_u u_{t-1} - \rho_v v_{t-1}(i) - \epsilon_t(i), \\
&\Leftrightarrow \epsilon_t(i) = x_t(i) - q_{t-1} - \rho_u u_{t-1} - \rho_v v_{t-1}(i) - e_t,
\end{aligned}$$

the terms  $\mathbb{E}_t [u_t]$  and  $\mathbb{E}_t [v_t(i)]$  are equal to:

$$\begin{aligned}
\mathbb{E}_t [u_t] &= \rho_u u_{t-1} + \mathbb{E}_t [e_t] \\
&= \rho_u u_{t-1} + \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} [x_t(i) - q_{t-1} - \rho_u u_{t-1} - \rho_v v_{t-1}(i)] \\
\mathbb{E}_t [v_t(i)] &= \rho_v v_{t-1}(i) + \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} [x_t(i) - q_{t-1} - \rho_u u_{t-1} - \rho_v v_{t-1}(i)].
\end{aligned}$$

It follows that:

$$\begin{aligned}
p_t^*(i) &= (1 - \beta\theta)(1 - r)x_t(i) + [(1 - \beta\theta)r + \beta\theta a_1] [\theta + (1 - \theta) a_1] p_{t-1} \\
&\quad + b_1 q_{t-1} + b_2 \mathbb{E}_t [u_t] + b_3 \mathbb{E}_t [v_t(i)] + b_4 u_{t-1} \\
&= (1 - \beta\theta)(1 - r)x_t(i) + [(1 - \beta\theta)r + \beta\theta a_1] [\theta + (1 - \theta) a_1] p_{t-1} \\
&\quad + b_2 \rho_u u_{t-1} + b_2 \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} [x_t(i) - q_{t-1} - \rho_u u_{t-1} - \rho_v v_{t-1}(i)] \\
&\quad + b_3 \rho_v v_{t-1}(i) + b_3 \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} [x_t(i) - q_{t-1} - \rho_u u_{t-1} - \rho_v v_{t-1}(i)] \\
&\quad + b_4 u_{t-1} + b_1 q_{t-1} \\
&= [(1 - \beta\theta)r + \beta\theta a_1] [\theta + (1 - \theta) a_1] p_{t-1} \\
&\quad + \left[ (1 - \beta\theta)(1 - r) + b_2 \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} + b_3 \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \right] x_t(i) \\
&\quad + \left[ b_1 - b_2 \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} - b_3 \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \right] q_{t-1} \\
&\quad + \left[ b_4 + (b_2 - b_3) \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \rho_u \right] u_{t-1} + [b_3 - b_2] \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} \rho_v v_{t-1}(i),
\end{aligned}$$

and thus the equilibrium conditions are:

$$\begin{aligned}
a_1 &= [(1 - \beta\theta)r + \beta\theta a_1] [\theta + (1 - \theta) a_1], \\
a_2 &= (1 - \beta\theta)(1 - r) + b_2 \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} + b_3 \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2}, \\
a_3 &= b_1 - b_2 \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} - b_3 \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2}, \\
a_4 &= b_4 + (b_2 - b_3) \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \rho_u, \\
a_5 &= [b_3 - b_2] \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} \rho_v,
\end{aligned}$$

By simplifying the conditions, we obtain:

$$a_1 = [(1 - \beta\theta)r + \beta\theta a_1] [\theta + (1 - \theta) a_1],$$

$$\begin{aligned}
a_2 &= (1 - \beta\theta)(1 - r) \\
&\quad + [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) a_2 + \beta\theta (a_2 + a_3) \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} \\
&\quad + \beta\theta (a_2 \rho_u + a_4) \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} + \beta\theta (a_2 \rho_v + a_5) \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \\
&= (1 - \beta\theta)(1 - r) \\
&\quad + \left[ [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) + \beta\theta \right] \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} + \beta\theta \left[ \rho_u \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} + \rho_v \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \right] a_2 \\
&\quad + \beta\theta \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} a_3 + \beta\theta \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} a_4 + \beta\theta \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} a_5, \\
a_3 &= [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) a_2 + \beta\theta (a_2 + a_3) \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \\
&\quad + [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) a_3 - \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} \beta\theta (a_2 \rho_u + a_4) \\
&\quad - \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \beta\theta (a_2 \rho_v + a_5) \\
&= \left[ [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) + \beta\theta \right] \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} - \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} \beta\theta \rho_u - \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \beta\theta \rho_v \Big] a_2 \\
&\quad + \left[ \beta\theta \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} + [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) \right] a_3 \\
&\quad - \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} \beta\theta a_4 - \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \beta\theta a_5, \\
a_4 &= [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) a_4 \\
&\quad + \left[ [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) a_2 + \beta\theta (a_2 + a_3) \right. \\
&\quad \quad \left. + \beta\theta (a_2 \rho_u + a_4) - \beta\theta (a_2 \rho_v + a_5) \right] \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \rho_u \\
&= [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) + \beta\theta + \beta\theta \rho_u - \beta\theta \rho_v \Big] \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \rho_u a_2 + \beta\theta \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \rho_u a_3 \\
&\quad + \left[ [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) + \beta\theta \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \rho_u \right] a_4 - \beta\theta \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \rho_u a_5, \\
a_5 &= - \left[ [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) a_2 + \beta\theta (a_2 + a_3) \right. \\
&\quad \quad \left. + \beta\theta (a_2 \rho_u + a_4) - \beta\theta (a_2 \rho_v + a_5) \right] \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} \rho_v \\
&= - [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) + \beta\theta + \beta\theta \rho_u - \beta\theta \rho_v \Big] \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} \rho_v a_2 \\
&\quad - \beta\theta \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} \rho_v a_3 - \beta\theta \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} \rho_v a_4 + \beta\theta \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} \rho_v a_5. \square
\end{aligned}$$

In an extreme case of flexible prices, plugging  $\theta = 0$  into conditions for  $(a_1, a_2, a_3, a_4, a_5)$  yields:

$$a_1 = r a_1 = 0,$$

$$\begin{aligned}
a_2 &= (1-r) + ra_2 \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} = \frac{1-r}{1-r \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2}} \\
a_3 &= ra_2 \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} + ra_3 = \frac{r}{1-r} \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} a_2 = \frac{r}{1-r} \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \frac{1-r}{1-r \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2}} \\
a_4 &= ra_4 + ra_2 \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \rho_u = \frac{r}{1-r} \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \rho_u a_2 = \frac{r}{1-r} \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} \rho_u \frac{1-r}{1-r \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2}} \\
a_5 &= -r \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} \rho_v a_2 = -r \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} \rho_v \frac{1-r}{1-r \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2}}. \square
\end{aligned}$$

## D.5 Proof of Proposition 6

Based on the following relationship  $\alpha_2 \equiv a_2$ ,  $\alpha_3 \equiv a_3 + a_4$ ,  $\alpha_4 \equiv -a_4$ , and  $\alpha_5 \equiv a_5$ ,  $\alpha_2$ ,  $\alpha_3$ ,  $\alpha_4$ , and  $\alpha_5$  are transformed as follows.

$$\begin{aligned}
\alpha_2 &\equiv a_2 = \frac{1-r}{1-r \frac{1}{1+(\tau_t/\sigma_t)^2}} \\
\alpha_3 &\equiv a_3 + a_4 = (1+\rho_u) \frac{r}{1-r} \frac{(\tau_t/\sigma_t)^2}{1+(\tau_t/\sigma_t)^2} \frac{1-r}{1-r \frac{1}{1+(\tau_t/\sigma_t)^2}} \\
\alpha_4 &\equiv -a_4 = -\frac{r}{1-r} \frac{(\tau_t/\sigma_t)^2}{1+(\tau_t/\sigma_t)^2} \rho_u \frac{1-r}{1-r \frac{1}{1+(\tau_t/\sigma_t)^2}} \\
\alpha_5 &\equiv a_5 = -r \frac{1}{1+(\tau_t/\sigma_t)^2} \rho_v \frac{1-r}{1-r \frac{1}{1+(\tau_t/\sigma_t)^2}}
\end{aligned}$$

Then the following inequalities hold:

$$\begin{aligned}
\frac{\partial \alpha_2}{\partial (\tau_t/\sigma_t)} &= -\frac{2r(1-r)(\tau_t/\sigma_t)}{((\tau_t/\sigma_t)^2 + 1 - r)^2} < 0 \\
\frac{\partial \alpha_3}{\partial (\tau_t/\sigma_t)} &= \frac{2r(1-r)(1+\rho_u)(\tau_t/\sigma_t)}{((\tau_t/\sigma_t)^2 + 1 - r)^2} > 0 \\
\frac{\partial \alpha_4}{\partial (\tau_t/\sigma_t)} &= -\rho_u \frac{2r(1-r)(\tau_t/\sigma_t)}{((\tau_t/\sigma_t)^2 + 1 - r)^2} < 0 \\
\frac{\partial \alpha_5}{\partial (\tau_t/\sigma_t)} &= \rho_v \frac{2r(1-r)(\tau_t/\sigma_t)}{((\tau_t/\sigma_t)^2 + 1 - r)^2}. \square
\end{aligned}$$

## D.6 Proof of Corollary 1

If  $\rho_u = \rho_v = 0$  holds, then the conditions become  $a_4 = a_5 = 0$ ,

$$a_1 = [(1 - \beta\theta)r + \beta\theta a_1] [\theta + (1 - \theta) a_1],$$

$$\begin{aligned} a_2 = (1 - \beta\theta)(1 - r) &+ [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) + \beta\theta \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} a_2 \\ &+ \beta\theta \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} a_3, \end{aligned}$$

and

$$\begin{aligned} a_3 &= [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) + \beta\theta \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} a_2 \\ &+ \left[ \beta\theta \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} + [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) \right] a_3. \end{aligned}$$

Moreover,  $a_1 + a_2 + a_3 = 1$  holds because if  $a_1 + a_2 + a_3 = 1$  holds, in reality

$$\begin{aligned} a_1 + a_2 + a_3 &= [(1 - \beta\theta)r + \beta\theta a_1] [\theta + (1 - \theta) a_1] \\ &+ (1 - \beta\theta)(1 - r) + [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) + \beta\theta \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} a_2 \\ &+ \beta\theta \frac{\sigma_t^2}{\sigma_t^2 + \tau_t^2} a_3 + [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) + \beta\theta \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} a_2 \\ &+ \left[ \beta\theta \frac{\tau_t^2}{\sigma_t^2 + \tau_t^2} + [(1 - \beta\theta)r + \beta\theta a_1] (1 - \theta) \right] a_3 \\ &= [(1 - \beta\theta)r + \beta\theta a_1] [\theta + (1 - \theta) a_1 + (1 - \theta) a_2 + (1 - \theta) a_3] \\ &+ (1 - \beta\theta)(1 - r) + \beta\theta a_2 + \beta\theta a_3 \\ &= (1 - \beta\theta)r + (1 - \beta\theta)(1 - r) + \beta\theta a_1 + \beta\theta a_2 + \beta\theta a_3 \\ &= 1 - \beta\theta + \beta\theta (a_1 + a_2 + a_3) = 1 \end{aligned}$$

holds. Next, given  $a_1 + a_2 + a_3 = 1$  and cash-in-advance constraint  $q_t = p_t + y_t$ , the equation (26) is expressed as follows.

$$\begin{aligned} p_t - p_{t-1} &= [\theta + (1 - \theta) a_1] (p_{t-1} - p_{t-1}) + (1 - \theta) a_2 (q_t - p_{t-1}) + (1 - \theta) a_3 (q_{t-1} - p_{t-1}), \\ \Leftrightarrow \pi_t &= (1 - \theta) a_2 (\pi_t + y_t) + (1 - \theta) a_3 (y_{t-1}), \\ \Leftrightarrow \pi_t &= \frac{(1 - \theta) a_2}{1 - (1 - \theta) a_2} y_t + \frac{(1 - \theta) a_3}{1 - (1 - \theta) a_2} y_{t-1}. \square \end{aligned}$$

## **E Business Outlook Survey**

The Business Outlook Survey, administered by the Ministry of Finance, covers 37 sectors of the economy from the second quarter of 2004 to the first quarter of 2023 fiscal year.<sup>37</sup> This survey analyzes business leaders' assessments and forecasts for the economy, providing essential information to track economic trends. It encompasses approximately 15,000 companies with headquarters or principal offices in Japan and capital stock of 10 million yen or more. Conducted through self-reporting questionnaires by mail or online, the survey takes place on the 15th day of May, August, November, and February. Tables A1, A2, A3, A4, A5, and A6 show the summary statistics of the sample sectors.

## **F Annual Survey of Corporate Behavior**

The Annual Survey of Corporate Behavior (ASCB), conducted by the Cabinet Office of Japan, spans 33 sectors of the economy from the fiscal year 2003 to 2021.<sup>38</sup> The survey is conducted annually in January. The Economic and Social Research Institute in the Cabinet Office of Japan directly surveys approximately 1,000 public-listed Japanese firms on nominal and real growth rates of the Japanese economy as well as nominal and real growth rates of demand in their respective sectors. The Cabinet Office of Japan releases the arithmetic averages of the individual firms' expectations within each sector while retaining the data on the expectations of the individual firms confidential. Tables A7 and A8 show the summary statistics of the sample sectors.

## **G Financial Statements Statistics of Corporations Data**

We use quarterly data on sector-level sales of Japanese firms from the Financial Statements Statistics of Corporations by Industry, compiled by the Ministry of Finance of Japan.<sup>39</sup> The data cover the period 1975:Q3-2022:Q4 for 29 major sectors in the economy. Table A9 reports summary statistics.

---

<sup>37</sup>The data is available at <https://www.mof.go.jp/english/pri/reference/bos/index.htm>.

<sup>38</sup>The data is available at <https://www.esri.cao.go.jp/en/stat/ank/ank-e.html>.

<sup>39</sup>The data is available at <http://www.mof.go.jp/english/pri/reference/ssc/index.htm>.

Table A1: Summary statistics about Business Outlook Survey (Large firms, current)

| <i>Dataset: Business Outlook Survey; 37 industries; 2004/2Q-2023/1Q</i> |                                |                                    |                                          |                                    |                                         |                                    |
|-------------------------------------------------------------------------|--------------------------------|------------------------------------|------------------------------------------|------------------------------------|-----------------------------------------|------------------------------------|
| <i>Sector</i>                                                           | <i>(1) Historical averages</i> |                                    | <i>(2) Historical standard deviation</i> |                                    | <i>(3) First-order auto correlation</i> |                                    |
|                                                                         | <i>Own business conditions</i> | <i>General business conditions</i> | <i>Own business conditions</i>           | <i>General business conditions</i> | <i>Own business conditions</i>          | <i>General business conditions</i> |
| <i>Foods</i>                                                            | -3.58                          | -3.41                              | 12.89                                    | 18.39                              | -0.15                                   | 0.47                               |
| <i>Textiles</i>                                                         | -4.59                          | -4.24                              | 15.18                                    | 22.28                              | 0.36                                    | 0.46                               |
| <i>Wood Products</i>                                                    | 0.24                           | 0.66                               | 37.88                                    | 33.65                              | 0.14                                    | 0.39                               |
| <i>Pulp and Paper</i>                                                   | -4.68                          | -4.15                              | 16.38                                    | 17.52                              | -0.14                                   | 0.49                               |
| <i>Chemicals</i>                                                        | -0.69                          | -0.87                              | 12.09                                    | 18.11                              | 0.30                                    | 0.53                               |
| <i>Oil and Coal Products</i>                                            | -7.37                          | -0.55                              | 22.19                                    | 22.80                              | 0.24                                    | 0.33                               |
| <i>Glass and Ceramics Products</i>                                      | -2.86                          | -1.39                              | 15.77                                    | 23.07                              | 0.43                                    | 0.58                               |
| <i>Iron and Steel</i>                                                   | -6.75                          | -1.77                              | 22.53                                    | 26.19                              | 0.39                                    | 0.53                               |
| <i>Nonferrous Metals</i>                                                | -3.80                          | -2.23                              | 18.89                                    | 22.56                              | 0.50                                    | 0.50                               |
| <i>Metal Product</i>                                                    | -2.57                          | -2.81                              | 18.21                                    | 22.96                              | 0.31                                    | 0.54                               |
| <i>General-Purpose Machinery</i>                                        | 2.62                           | -0.30                              | 17.60                                    | 20.47                              | -0.03                                   | 0.36                               |
| <i>Production Machinery</i>                                             | 5.10                           | 2.89                               | 20.21                                    | 20.39                              | 0.29                                    | 0.31                               |
| <i>Business Oriented Machinery</i>                                      | 3.79                           | 2.88                               | 15.33                                    | 16.58                              | -0.26                                   | 0.13                               |
| <i>Electrical Machinery</i>                                             | -0.17                          | -0.33                              | 17.15                                    | 21.90                              | 0.25                                    | 0.49                               |
| <i>Electric Device</i>                                                  | 0.53                           | 0.66                               | 20.35                                    | 21.63                              | 0.28                                    | 0.46                               |
| <i>Cars and Related Products</i>                                        | -2.49                          | -0.34                              | 29.10                                    | 28.84                              | 0.06                                    | 0.19                               |
| <i>Other Transportation Equipment</i>                                   | -6.81                          | -2.95                              | 17.12                                    | 20.02                              | 0.09                                    | 0.46                               |
| <i>Other Products</i>                                                   | -2.50                          | -1.67                              | 14.67                                    | 21.27                              | 0.42                                    | 0.56                               |
| <i>Agriculture, Forestry, and Fishing</i>                               | -1.68                          | 6.47                               | 38.12                                    | 32.89                              | -0.34                                   | 0.35                               |
| <i>Mining and Quarrying of Stone and Gravel</i>                         | -2.86                          | -2.67                              | 13.16                                    | 12.84                              | -0.06                                   | 0.46                               |
| <i>Construction</i>                                                     | 1.00                           | -1.72                              | 17.30                                    | 20.49                              | -0.24                                   | 0.62                               |
| <i>Electricity, Gas, Heat supply and Water</i>                          | -2.50                          | 2.17                               | 8.94                                     | 16.98                              | -0.22                                   | 0.60                               |
| <i>Information and Communications</i>                                   | 0.64                           | -1.62                              | 13.00                                    | 20.60                              | 0.08                                    | 0.62                               |
| <i>Transport and Postal Activities</i>                                  | -2.49                          | -1.18                              | 14.89                                    | 22.04                              | 0.17                                    | 0.47                               |
| <i>Whole-sale</i>                                                       | -0.78                          | -1.03                              | 14.63                                    | 21.01                              | 0.44                                    | 0.58                               |
| <i>Retail</i>                                                           | 1.34                           | -4.25                              | 14.54                                    | 24.18                              | 0.25                                    | 0.50                               |
| <i>Real Estate</i>                                                      | -3.96                          | -4.99                              | 13.09                                    | 21.83                              | 0.36                                    | 0.58                               |
| <i>Lease</i>                                                            | -1.19                          | -2.18                              | 15.37                                    | 21.09                              | 0.45                                    | 0.60                               |
| <i>Goods Rental and Leasing</i>                                         | -1.34                          | 2.76                               | 28.41                                    | 25.45                              | 0.08                                    | 0.18                               |
| <i>Accommodations, Eating and Drinking Services</i>                     | -1.60                          | -2.15                              | 27.17                                    | 31.58                              | -0.05                                   | 0.33                               |
| <i>Living-Related and Personal Services</i>                             | 4.90                           | 3.17                               | 25.36                                    | 27.35                              | 0.18                                    | 0.36                               |
| <i>Services for Amusement and Hobbies</i>                               | 1.31                           | -3.49                              | 24.34                                    | 26.78                              | -0.03                                   | 0.34                               |
| <i>Scientific Research, Professional and Technical Services</i>         | 0.52                           | -0.85                              | 7.36                                     | 16.71                              | 0.33                                    | 0.37                               |
| <i>Healthcare and Education</i>                                         | 8.32                           | 0.50                               | 17.33                                    | 26.36                              | 0.19                                    | 0.48                               |
| <i>Employment and Worker Dispatching Services</i>                       | 11.44                          | 13.09                              | 31.45                                    | 31.27                              | 0.23                                    | 0.36                               |
| <i>Other Service</i>                                                    | 2.66                           | 0.37                               | 9.59                                     | 16.39                              | 0.07                                    | 0.31                               |
| <i>Finance and Insurance</i>                                            | -3.02                          | 0.99                               | 11.92                                    | 27.66                              | 0.60                                    | 0.63                               |

Table A2: Summary statistics about Business Outlook Survey (Mid-sized firms, current)

| <i>Dataset: Business Outlook Survey; 37 industries; 2004/2Q-2023/1Q</i> |                                |                                    |                                          |                                    |                                         |                                    |
|-------------------------------------------------------------------------|--------------------------------|------------------------------------|------------------------------------------|------------------------------------|-----------------------------------------|------------------------------------|
| <i>Sector</i>                                                           | <i>(1) Historical averages</i> |                                    | <i>(2) Historical standard deviation</i> |                                    | <i>(3) First-order auto correlation</i> |                                    |
|                                                                         | <i>Own business conditions</i> | <i>General business conditions</i> | <i>Own business conditions</i>           | <i>General business conditions</i> | <i>Own business conditions</i>          | <i>General business conditions</i> |
| <i>Foods</i>                                                            | -7.10                          | -8.84                              | 16.73                                    | 24.06                              | -0.18                                   | 0.53                               |
| <i>Textiles</i>                                                         | -19.28                         | -19.85                             | 21.05                                    | 23.35                              | 0.17                                    | 0.56                               |
| <i>Wood Products</i>                                                    | -5.39                          | -7.46                              | 28.45                                    | 31.07                              | 0.18                                    | 0.48                               |
| <i>Pulp and Paper</i>                                                   | -11.14                         | -10.78                             | 23.36                                    | 27.19                              | -0.05                                   | 0.36                               |
| <i>Chemicals</i>                                                        | -3.34                          | -2.73                              | 15.38                                    | 22.24                              | 0.22                                    | 0.57                               |
| <i>Oil and Coal Products</i>                                            | 1.04                           | 2.88                               | 28.81                                    | 27.82                              | 0.05                                    | 0.51                               |
| <i>Glass and Ceramics Products</i>                                      | -6.88                          | -7.58                              | 19.72                                    | 25.54                              | 0.35                                    | 0.65                               |
| <i>Iron and Steel</i>                                                   | -8.44                          | -7.17                              | 24.12                                    | 28.12                              | 0.36                                    | 0.49                               |
| <i>Nonferrous Metals</i>                                                | -11.77                         | -9.69                              | 22.77                                    | 26.59                              | 0.32                                    | 0.48                               |
| <i>Metal Product</i>                                                    | -6.58                          | -5.54                              | 22.57                                    | 25.06                              | 0.39                                    | 0.47                               |
| <i>General-Purpose Machinery</i>                                        | -1.51                          | -2.75                              | 20.55                                    | 21.05                              | -0.07                                   | 0.20                               |
| <i>Production Machinery</i>                                             | 0.25                           | -3.52                              | 16.32                                    | 20.40                              | 0.25                                    | 0.50                               |
| <i>Business Oriented Machinery</i>                                      | -1.73                          | -3.06                              | 17.12                                    | 19.03                              | 0.19                                    | -0.05                              |
| <i>Electrical Machinery</i>                                             | -3.21                          | -3.45                              | 20.21                                    | 23.01                              | 0.31                                    | 0.66                               |
| <i>Electric Device</i>                                                  | -4.40                          | -6.81                              | 19.37                                    | 24.01                              | 0.38                                    | 0.52                               |
| <i>Cars and Related Products</i>                                        | -5.25                          | -2.83                              | 30.45                                    | 30.30                              | 0.12                                    | 0.26                               |
| <i>Other Transportation Equipment</i>                                   | -4.21                          | -6.90                              | 25.69                                    | 25.92                              | -0.24                                   | 0.20                               |
| <i>Other Products</i>                                                   | -9.51                          | -7.68                              | 15.67                                    | 24.34                              | 0.48                                    | 0.64                               |
| <i>Agriculture, Forestry, and Fishing</i>                               | -12.46                         | -12.94                             | 19.13                                    | 25.35                              | 0.31                                    | 0.42                               |
| <i>Mining and Quarrying of Stone and Gravel</i>                         | -10.01                         | -14.63                             | 21.71                                    | 25.75                              | 0.39                                    | 0.44                               |
| <i>Construction</i>                                                     | -4.05                          | -7.81                              | 16.45                                    | 25.32                              | 0.28                                    | 0.70                               |
| <i>Electricity, Gas, Heat supply and Water</i>                          | -6.31                          | -5.82                              | 13.36                                    | 22.67                              | 0.23                                    | 0.60                               |
| <i>Information and Communications</i>                                   | -1.16                          | -5.16                              | 14.84                                    | 24.15                              | 0.31                                    | 0.68                               |
| <i>Transport and Postal Activities</i>                                  | -9.98                          | -7.97                              | 15.97                                    | 24.04                              | 0.30                                    | 0.52                               |
| <i>Whole-sale</i>                                                       | -6.77                          | -7.63                              | 14.60                                    | 23.83                              | 0.45                                    | 0.65                               |
| <i>Retail</i>                                                           | -7.94                          | -8.26                              | 16.18                                    | 25.68                              | 0.13                                    | 0.51                               |
| <i>Real Estate</i>                                                      | -6.53                          | -9.65                              | 9.63                                     | 22.88                              | 0.53                                    | 0.68                               |
| <i>Lease</i>                                                            | -7.67                          | -6.53                              | 16.80                                    | 24.11                              | 0.32                                    | 0.64                               |
| <i>Goods Rental and Leasing</i>                                         | -5.20                          | -12.64                             | 27.49                                    | 27.29                              | -0.12                                   | 0.37                               |
| <i>Accommodations, Eating and Drinking Services</i>                     | -11.51                         | -8.44                              | 26.32                                    | 30.59                              | 0.05                                    | 0.41                               |
| <i>Living-Related and Personal Services</i>                             | -5.51                          | -8.07                              | 24.46                                    | 26.58                              | 0.19                                    | 0.40                               |
| <i>Services for Amusement and Hobbies</i>                               | -9.90                          | -11.18                             | 21.28                                    | 25.70                              | -0.10                                   | 0.39                               |
| <i>Scientific Research, Professional and Technical Services</i>         | -1.28                          | -5.40                              | 12.54                                    | 19.83                              | 0.17                                    | 0.48                               |
| <i>Healthcare and Education</i>                                         | 4.05                           | -3.27                              | 16.74                                    | 26.28                              | 0.24                                    | 0.54                               |
| <i>Employment and Worker Dispatching Services</i>                       | 8.91                           | 0.26                               | 22.35                                    | 29.23                              | 0.24                                    | 0.51                               |
| <i>Other Service</i>                                                    | -1.55                          | -5.45                              | 11.71                                    | 19.85                              | 0.17                                    | 0.39                               |
| <i>Finance and Insurance</i>                                            | -6.47                          | -3.57                              | 14.49                                    | 28.92                              | 0.43                                    | 0.66                               |



Table A3: Summary statistics about Business Outlook Survey (Small firms, current)

| <i>Dataset: Business Outlook Survey; 37 industries; 2004/2Q-2023/1Q</i> |                                |                                    |                                          |                                    |                                         |                                    |
|-------------------------------------------------------------------------|--------------------------------|------------------------------------|------------------------------------------|------------------------------------|-----------------------------------------|------------------------------------|
| <i>Sector</i>                                                           | <i>(1) Historical averages</i> |                                    | <i>(2) Historical standard deviation</i> |                                    | <i>(3) First-order auto correlation</i> |                                    |
|                                                                         | <i>Own business conditions</i> | <i>General business conditions</i> | <i>Own business conditions</i>           | <i>General business conditions</i> | <i>Own business conditions</i>          | <i>General business conditions</i> |
| <i>Foods</i>                                                            | -22.97                         | -24.72                             | 16.98                                    | 20.55                              | 0.24                                    | 0.42                               |
| <i>Textiles</i>                                                         | -26.90                         | -28.83                             | 15.82                                    | 22.08                              | 0.35                                    | 0.40                               |
| <i>Wood Products</i>                                                    | -28.19                         | -25.77                             | 20.23                                    | 23.34                              | 0.39                                    | 0.62                               |
| <i>Pulp and Paper</i>                                                   | -22.07                         | -22.17                             | 18.38                                    | 23.91                              | 0.12                                    | 0.56                               |
| <i>Chemicals</i>                                                        | -12.66                         | -16.51                             | 16.63                                    | 22.30                              | 0.24                                    | 0.50                               |
| <i>Oil and Coal Products</i>                                            | -17.25                         | -18.15                             | 15.45                                    | 20.10                              | 0.30                                    | 0.44                               |
| <i>Glass and Ceramics Products</i>                                      | -22.26                         | -24.95                             | 18.81                                    | 22.75                              | 0.33                                    | 0.60                               |
| <i>Iron and Steel</i>                                                   | -14.78                         | -14.57                             | 21.29                                    | 28.04                              | 0.53                                    | 0.73                               |
| <i>Nonferrous Metals</i>                                                | -17.88                         | -19.13                             | 22.62                                    | 27.32                              | 0.46                                    | 0.62                               |
| <i>Metal Product</i>                                                    | -17.58                         | -19.81                             | 21.71                                    | 25.11                              | 0.61                                    | 0.66                               |
| <i>General-Purpose Machinery</i>                                        | -12.44                         | -17.96                             | 19.56                                    | 25.37                              | 0.46                                    | 0.63                               |
| <i>Production Machinery</i>                                             | -10.96                         | -16.18                             | 18.22                                    | 22.12                              | 0.40                                    | 0.53                               |
| <i>Business Oriented Machinery</i>                                      | -12.96                         | -14.52                             | 17.28                                    | 20.60                              | 0.43                                    | 0.34                               |
| <i>Electrical Machinery</i>                                             | -16.08                         | -17.51                             | 19.43                                    | 26.28                              | 0.54                                    | 0.68                               |
| <i>Electric Device</i>                                                  | -15.83                         | -17.63                             | 19.53                                    | 22.53                              | 0.41                                    | 0.43                               |
| <i>Cars and Related Products</i>                                        | -13.08                         | -16.44                             | 27.06                                    | 30.75                              | 0.42                                    | 0.44                               |
| <i>Other Transportation Equipment</i>                                   | -19.63                         | -18.86                             | 16.60                                    | 24.53                              | 0.39                                    | 0.61                               |
| <i>Other Products</i>                                                   | -22.54                         | -25.20                             | 13.47                                    | 19.83                              | 0.53                                    | 0.70                               |
| <i>Agriculture, Forestry, and Fishing</i>                               | -15.65                         | -21.31                             | 18.59                                    | 23.25                              | 0.34                                    | 0.51                               |
| <i>Mining and Quarrying of Stone and Gravel</i>                         | -22.86                         | -26.76                             | 19.09                                    | 21.70                              | 0.31                                    | 0.56                               |
| <i>Construction</i>                                                     | -17.86                         | -21.35                             | 14.63                                    | 21.26                              | 0.64                                    | 0.82                               |
| <i>Electricity, Gas, Heat supply and Water</i>                          | -                              | -                                  | -                                        | -                                  | -                                       | -                                  |
| <i>Information and Communications</i>                                   | -9.44                          | -12.63                             | 14.07                                    | 24.93                              | 0.45                                    | 0.71                               |
| <i>Transport and Postal Activities</i>                                  | -20.34                         | -21.06                             | 16.45                                    | 22.30                              | 0.41                                    | 0.69                               |
| <i>Whole-sale</i>                                                       | -23.21                         | -24.46                             | 12.57                                    | 20.45                              | 0.50                                    | 0.70                               |
| <i>Retail</i>                                                           | -27.28                         | -29.27                             | 12.12                                    | 20.09                              | 0.39                                    | 0.64                               |
| <i>Real Estate</i>                                                      | -12.36                         | -17.14                             | 10.12                                    | 21.10                              | 0.78                                    | 0.78                               |
| <i>Lease</i>                                                            | -16.62                         | -17.99                             | 20.50                                    | 26.59                              | 0.50                                    | 0.77                               |
| <i>Goods Rental and Leasing</i>                                         | -19.06                         | -20.51                             | 17.39                                    | 24.59                              | 0.37                                    | 0.53                               |
| <i>Accommodations, Eating and Drinking Services</i>                     | -22.97                         | -24.54                             | 20.52                                    | 26.39                              | 0.08                                    | 0.32                               |
| <i>Living-Related and Personal Services</i>                             | -21.28                         | -21.73                             | 16.51                                    | 25.47                              | 0.25                                    | 0.64                               |
| <i>Services for Amusement and Hobbies</i>                               | -19.32                         | -20.38                             | 17.97                                    | 22.85                              | 0.15                                    | 0.55                               |
| <i>Scientific Research, Professional and Technical Services</i>         | -12.90                         | -18.26                             | 12.50                                    | 21.92                              | 0.58                                    | 0.69                               |
| <i>Healthcare and Education</i>                                         | -12.70                         | -17.56                             | 13.73                                    | 22.78                              | 0.22                                    | 0.61                               |
| <i>Employment and Worker Dispatching Services</i>                       | -11.90                         | -13.55                             | 19.29                                    | 23.43                              | 0.36                                    | 0.48                               |
| <i>Other Service</i>                                                    | -16.82                         | -20.74                             | 12.54                                    | 20.52                              | 0.47                                    | 0.64                               |
| <i>Finance and Insurance</i>                                            | -                              | -                                  | -                                        | -                                  | -                                       | -                                  |

Table A4: Summary statistics about Business Outlook Survey (Large firms, future)

| <i>Dataset: Business Outlook Survey; 37 industries; 2004/2Q-2023/1Q</i> |                                |                                    |                                          |                                    |                                         |                                    |
|-------------------------------------------------------------------------|--------------------------------|------------------------------------|------------------------------------------|------------------------------------|-----------------------------------------|------------------------------------|
| <i>Sector</i>                                                           | <i>(1) Historical averages</i> |                                    | <i>(2) Historical standard deviation</i> |                                    | <i>(3) First-order auto correlation</i> |                                    |
|                                                                         | <i>Own business conditions</i> | <i>General business conditions</i> | <i>Own business conditions</i>           | <i>General business conditions</i> | <i>Own business conditions</i>          | <i>General business conditions</i> |
| <i>Foods</i>                                                            | 0.79                           | -0.20                              | 9.43                                     | 10.22                              | -0.25                                   | 0.38                               |
| <i>Textiles</i>                                                         | 2.42                           | 1.19                               | 9.04                                     | 13.35                              | 0.26                                    | 0.48                               |
| <i>Wood Products</i>                                                    | 5.03                           | 5.76                               | 30.09                                    | 27.01                              | 0.11                                    | 0.17                               |
| <i>Pulp and Paper</i>                                                   | 2.43                           | 0.81                               | 9.37                                     | 8.99                               | 0.00                                    | 0.28                               |
| <i>Chemicals</i>                                                        | 5.15                           | 2.79                               | 6.42                                     | 9.79                               | 0.08                                    | 0.42                               |
| <i>Oil and Coal Products</i>                                            | -1.80                          | -0.28                              | 8.27                                     | 8.18                               | 0.22                                    | 0.20                               |
| <i>Glass and Ceramics Products</i>                                      | 5.92                           | 2.31                               | 12.95                                    | 13.67                              | 0.28                                    | 0.51                               |
| <i>Iron and Steel</i>                                                   | 4.02                           | 3.25                               | 13.71                                    | 13.54                              | 0.25                                    | 0.35                               |
| <i>Nonferrous Metals</i>                                                | 3.12                           | 2.99                               | 11.53                                    | 12.07                              | 0.13                                    | 0.36                               |
| <i>Metal Product</i>                                                    | 2.61                           | 0.49                               | 13.32                                    | 13.97                              | 0.27                                    | 0.37                               |
| <i>General-Purpose Machinery</i>                                        | 7.41                           | 4.40                               | 11.88                                    | 12.23                              | -0.30                                   | 0.08                               |
| <i>Production Machinery</i>                                             | 8.05                           | 5.55                               | 10.66                                    | 10.59                              | 0.09                                    | 0.31                               |
| <i>Business Oriented Machinery</i>                                      | 6.88                           | 5.64                               | 11.05                                    | 9.13                               | -0.26                                   | 0.35                               |
| <i>Electrical Machinery</i>                                             | 6.56                           | 3.13                               | 11.43                                    | 12.49                              | 0.05                                    | 0.36                               |
| <i>Electric Device</i>                                                  | 9.73                           | 5.69                               | 10.71                                    | 10.51                              | 0.11                                    | 0.29                               |
| <i>Cars and Related Products</i>                                        | 3.16                           | 2.07                               | 16.46                                    | 15.77                              | 0.20                                    | 0.37                               |
| <i>Other Transportation Equipment</i>                                   | -3.16                          | 0.50                               | 13.85                                    | 11.97                              | 0.14                                    | 0.46                               |
| <i>Other Products</i>                                                   | 6.24                           | 3.71                               | 8.34                                     | 12.70                              | 0.34                                    | 0.53                               |
| <i>Agriculture, Forestry, and Fishing</i>                               | -1.15                          | 9.62                               | 32.58                                    | 27.71                              | -0.15                                   | 0.18                               |
| <i>Mining and Quarrying of Stone and Gravel</i>                         | -1.67                          | -0.63                              | 7.21                                     | 8.82                               | 0.08                                    | 0.47                               |
| <i>Construction</i>                                                     | 1.18                           | 1.14                               | 15.01                                    | 13.38                              | -0.47                                   | 0.60                               |
| <i>Electricity, Gas, Heat supply and Water</i>                          | -0.96                          | 3.00                               | 6.57                                     | 9.91                               | -0.34                                   | 0.62                               |
| <i>Information and Communications</i>                                   | 5.91                           | 1.51                               | 8.27                                     | 12.52                              | -0.03                                   | 0.67                               |
| <i>Transport and Postal Activities</i>                                  | 2.15                           | 2.26                               | 7.36                                     | 11.76                              | 0.46                                    | 0.56                               |
| <i>Whole-sale</i>                                                       | 4.71                           | 2.71                               | 9.30                                     | 12.45                              | 0.41                                    | 0.52                               |
| <i>Retail</i>                                                           | 5.99                           | 0.34                               | 10.72                                    | 16.04                              | 0.09                                    | 0.37                               |
| <i>Real Estate</i>                                                      | -1.84                          | -1.66                              | 8.01                                     | 13.09                              | 0.65                                    | 0.67                               |
| <i>Lease</i>                                                            | 3.69                           | 1.36                               | 9.87                                     | 12.97                              | 0.25                                    | 0.52                               |
| <i>Goods Rental and Leasing</i>                                         | 1.72                           | 3.24                               | 20.96                                    | 20.44                              | 0.09                                    | -0.05                              |
| <i>Accommodations, Eating and Drinking Services</i>                     | 6.58                           | 3.31                               | 16.96                                    | 18.92                              | 0.27                                    | 0.57                               |
| <i>Living-Related and Personal Services</i>                             | 13.49                          | 7.51                               | 14.60                                    | 17.20                              | -0.13                                   | 0.30                               |
| <i>Services for Amusement and Hobbies</i>                               | 7.64                           | 1.87                               | 15.66                                    | 16.37                              | 0.15                                    | 0.41                               |
| <i>Scientific Research, Professional and Technical Services</i>         | 3.41                           | 2.47                               | 4.09                                     | 9.56                               | 0.05                                    | 0.26                               |
| <i>Healthcare and Education</i>                                         | 11.85                          | 3.26                               | 12.30                                    | 15.00                              | 0.40                                    | 0.59                               |
| <i>Employment and Worker Dispatching Services</i>                       | 13.70                          | 7.50                               | 17.09                                    | 13.94                              | 0.39                                    | 0.12                               |
| <i>Other Service</i>                                                    | 5.27                           | 3.43                               | 6.18                                     | 10.65                              | 0.01                                    | 0.47                               |
| <i>Finance and Insurance</i>                                            | 2.87                           | 5.69                               | 7.41                                     | 17.43                              | 0.75                                    | 0.67                               |

Table A5: Summary statistics about Business Outlook Survey (Mid-sized firms, future)

| <i>Dataset: Business Outlook Survey; 37 industries; 2004/2Q-2023/1Q</i> |                                |                                    |                                          |                                    |                                         |                                    |
|-------------------------------------------------------------------------|--------------------------------|------------------------------------|------------------------------------------|------------------------------------|-----------------------------------------|------------------------------------|
| <i>Sector</i>                                                           | <i>(1) Historical averages</i> |                                    | <i>(2) Historical standard deviation</i> |                                    | <i>(3) First-order auto correlation</i> |                                    |
|                                                                         | <i>Own business conditions</i> | <i>General business conditions</i> | <i>Own business conditions</i>           | <i>General business conditions</i> | <i>Own business conditions</i>          | <i>General business conditions</i> |
| <i>Foods</i>                                                            | -2.04                          | -4.73                              | 14.06                                    | 16.37                              | -0.25                                   | 0.48                               |
| <i>Textiles</i>                                                         | -11.13                         | -11.18                             | 18.32                                    | 21.05                              | 0.29                                    | 0.41                               |
| <i>Wood Products</i>                                                    | -1.63                          | -3.87                              | 21.86                                    | 21.48                              | 0.10                                    | 0.15                               |
| <i>Pulp and Paper</i>                                                   | -1.32                          | -3.91                              | 17.68                                    | 17.75                              | -0.11                                   | 0.24                               |
| <i>Chemicals</i>                                                        | 3.24                           | 0.05                               | 10.39                                    | 14.29                              | -0.01                                   | 0.50                               |
| <i>Oil and Coal Products</i>                                            | 1.76                           | 1.26                               | 24.72                                    | 24.56                              | -0.04                                   | 0.06                               |
| <i>Glass and Ceramics Products</i>                                      | 1.35                           | -1.38                              | 17.27                                    | 18.17                              | 0.27                                    | 0.47                               |
| <i>Iron and Steel</i>                                                   | -0.76                          | -1.18                              | 17.95                                    | 18.85                              | 0.29                                    | 0.43                               |
| <i>Nonferrous Metals</i>                                                | -2.23                          | -3.26                              | 19.12                                    | 18.97                              | 0.10                                    | 0.31                               |
| <i>Metal Product</i>                                                    | 1.80                           | -0.59                              | 15.61                                    | 17.76                              | 0.24                                    | 0.47                               |
| <i>General-Purpose Machinery</i>                                        | 4.63                           | 1.02                               | 14.34                                    | 13.86                              | -0.16                                   | 0.17                               |
| <i>Production Machinery</i>                                             | 3.85                           | -0.94                              | 11.45                                    | 14.59                              | 0.28                                    | 0.27                               |
| <i>Business Oriented Machinery</i>                                      | 3.71                           | 0.34                               | 11.74                                    | 15.82                              | -0.13                                   | 0.36                               |
| <i>Electrical Machinery</i>                                             | 3.28                           | -0.81                              | 15.68                                    | 17.69                              | 0.25                                    | 0.50                               |
| <i>Electric Device</i>                                                  | 6.57                           | 2.26                               | 14.93                                    | 14.07                              | 0.10                                    | 0.28                               |
| <i>Cars and Related Products</i>                                        | -0.33                          | -2.32                              | 19.76                                    | 19.93                              | 0.19                                    | 0.35                               |
| <i>Other Transportation Equipment</i>                                   | -2.73                          | -5.49                              | 20.23                                    | 17.12                              | -0.23                                   | 0.31                               |
| <i>Other Products</i>                                                   | 2.55                           | -0.61                              | 11.86                                    | 16.31                              | 0.02                                    | 0.40                               |
| <i>Agriculture, Forestry, and Fishing</i>                               | -5.76                          | -7.84                              | 17.66                                    | 17.32                              | 0.22                                    | 0.05                               |
| <i>Mining and Quarrying of Stone and Gravel</i>                         | -7.55                          | -9.66                              | 17.89                                    | 19.21                              | 0.29                                    | 0.58                               |
| <i>Construction</i>                                                     | -2.24                          | -4.54                              | 13.64                                    | 18.96                              | 0.29                                    | 0.64                               |
| <i>Electricity, Gas, Heat supply and Water</i>                          | -1.09                          | -2.08                              | 12.14                                    | 13.98                              | 0.09                                    | 0.35                               |
| <i>Information and Communications</i>                                   | 4.57                           | -0.55                              | 11.55                                    | 17.38                              | 0.48                                    | 0.72                               |
| <i>Transport and Postal Activities</i>                                  | -2.77                          | -2.74                              | 11.50                                    | 15.25                              | 0.22                                    | 0.53                               |
| <i>Whole-sale</i>                                                       | 0.50                           | -2.33                              | 10.29                                    | 16.74                              | 0.44                                    | 0.55                               |
| <i>Retail</i>                                                           | -1.15                          | -3.98                              | 12.88                                    | 18.66                              | 0.13                                    | 0.50                               |
| <i>Real Estate</i>                                                      | -4.08                          | -6.67                              | 7.28                                     | 16.67                              | 0.67                                    | 0.72                               |
| <i>Lease</i>                                                            | -2.18                          | -0.11                              | 13.57                                    | 17.52                              | 0.21                                    | 0.51                               |
| <i>Goods Rental and Leasing</i>                                         | 7.14                           | -2.22                              | 26.93                                    | 23.33                              | 0.33                                    | 0.50                               |
| <i>Accommodations, Eating and Drinking Services</i>                     | -0.52                          | -2.29                              | 17.74                                    | 20.66                              | 0.35                                    | 0.60                               |
| <i>Living-Related and Personal Services</i>                             | 2.62                           | -2.91                              | 16.30                                    | 21.31                              | 0.22                                    | 0.65                               |
| <i>Services for Amusement and Hobbies</i>                               | -2.59                          | -5.34                              | 14.65                                    | 17.46                              | -0.06                                   | 0.54                               |
| <i>Scientific Research, Professional and Technical Services</i>         | 4.16                           | -0.99                              | 7.56                                     | 13.12                              | 0.30                                    | 0.49                               |
| <i>Healthcare and Education</i>                                         | 10.37                          | 0.82                               | 14.19                                    | 19.20                              | 0.28                                    | 0.58                               |
| <i>Employment and Worker Dispatching Services</i>                       | 14.23                          | 5.69                               | 21.95                                    | 22.28                              | 0.10                                    | 0.57                               |
| <i>Other Service</i>                                                    | 1.79                           | -1.07                              | 7.09                                     | 11.86                              | 0.30                                    | 0.37                               |
| <i>Finance and Insurance</i>                                            | 1.91                           | 1.56                               | 9.46                                     | 19.64                              | 0.51                                    | 0.62                               |

Table A6: Summary statistics about Business Outlook Survey (Small firms, future)

| <i>Dataset: Business Outlook Survey; 37 industries; 2004/2Q-2023/1Q</i> |                                |                                    |                                          |                                    |                                         |                                    |
|-------------------------------------------------------------------------|--------------------------------|------------------------------------|------------------------------------------|------------------------------------|-----------------------------------------|------------------------------------|
| <i>Sector</i>                                                           | <i>(1) Historical averages</i> |                                    | <i>(2) Historical standard deviation</i> |                                    | <i>(3) First-order auto correlation</i> |                                    |
|                                                                         | <i>Own business conditions</i> | <i>General business conditions</i> | <i>Own business conditions</i>           | <i>General business conditions</i> | <i>Own business conditions</i>          | <i>General business conditions</i> |
| <i>Foods</i>                                                            | -9.51                          | -14.50                             | 13.34                                    | 15.77                              | 0.12                                    | 0.51                               |
| <i>Textiles</i>                                                         | -14.72                         | -17.84                             | 11.78                                    | 16.69                              | 0.24                                    | 0.29                               |
| <i>Wood Products</i>                                                    | -13.91                         | -16.87                             | 16.04                                    | 16.12                              | 0.16                                    | 0.43                               |
| <i>Pulp and Paper</i>                                                   | -13.22                         | -13.73                             | 15.15                                    | 20.91                              | -0.12                                   | 0.32                               |
| <i>Chemicals</i>                                                        | -5.73                          | -9.11                              | 11.35                                    | 15.34                              | 0.29                                    | 0.48                               |
| <i>Oil and Coal Products</i>                                            | -12.07                         | -14.09                             | 12.54                                    | 16.03                              | 0.32                                    | 0.50                               |
| <i>Glass and Ceramics Products</i>                                      | -15.16                         | -17.27                             | 13.94                                    | 18.17                              | 0.45                                    | 0.54                               |
| <i>Iron and Steel</i>                                                   | -8.07                          | -9.36                              | 14.17                                    | 20.12                              | 0.40                                    | 0.52                               |
| <i>Nonferrous Metals</i>                                                | -10.03                         | -13.83                             | 16.78                                    | 20.27                              | 0.31                                    | 0.41                               |
| <i>Metal Product</i>                                                    | -10.44                         | -13.00                             | 13.55                                    | 17.49                              | 0.56                                    | 0.62                               |
| <i>General-Purpose Machinery</i>                                        | -9.46                          | -12.63                             | 13.45                                    | 17.06                              | 0.43                                    | 0.34                               |
| <i>Production Machinery</i>                                             | -5.65                          | -9.90                              | 11.08                                    | 14.72                              | 0.24                                    | 0.49                               |
| <i>Business Oriented Machinery</i>                                      | -4.91                          | -10.77                             | 11.61                                    | 15.72                              | 0.45                                    | 0.52                               |
| <i>Electrical Machinery</i>                                             | -8.19                          | -11.03                             | 15.97                                    | 20.04                              | 0.61                                    | 0.66                               |
| <i>Electric Device</i>                                                  | -6.51                          | -11.46                             | 13.38                                    | 15.60                              | 0.21                                    | 0.40                               |
| <i>Cars and Related Products</i>                                        | -9.49                          | -13.84                             | 18.96                                    | 22.07                              | 0.31                                    | 0.53                               |
| <i>Other Transportation Equipment</i>                                   | -9.80                          | -13.27                             | 15.05                                    | 19.49                              | 0.51                                    | 0.63                               |
| <i>Other Products</i>                                                   | -12.07                         | -15.69                             | 9.35                                     | 14.27                              | 0.20                                    | 0.46                               |
| <i>Agriculture, Forestry, and Fishing</i>                               | -5.87                          | -13.62                             | 13.16                                    | 17.56                              | 0.07                                    | 0.37                               |
| <i>Mining and Quarrying of Stone and Gravel</i>                         | -12.36                         | -18.66                             | 14.87                                    | 15.95                              | 0.43                                    | 0.56                               |
| <i>Construction</i>                                                     | -11.38                         | -15.78                             | 9.94                                     | 15.05                              | 0.79                                    | 0.80                               |
| <i>Electricity, Gas, Heat supply and Water</i>                          | -                              | -                                  | -                                        | -                                  | -                                       | -                                  |
| <i>Information and Communications</i>                                   | -4.68                          | -9.42                              | 10.74                                    | 19.49                              | 0.49                                    | 0.72                               |
| <i>Transport and Postal Activities</i>                                  | -10.88                         | -14.00                             | 11.47                                    | 16.11                              | 0.49                                    | 0.69                               |
| <i>Whole-sale</i>                                                       | -13.09                         | -16.71                             | 9.84                                     | 15.50                              | 0.35                                    | 0.58                               |
| <i>Retail</i>                                                           | -16.03                         | -21.07                             | 8.38                                     | 15.07                              | 0.46                                    | 0.59                               |
| <i>Real Estate</i>                                                      | -7.42                          | -12.41                             | 7.19                                     | 15.71                              | 0.82                                    | 0.76                               |
| <i>Lease</i>                                                            | -9.59                          | -12.98                             | 16.54                                    | 19.98                              | 0.32                                    | 0.66                               |
| <i>Goods Rental and Leasing</i>                                         | -9.64                          | -14.82                             | 12.93                                    | 16.91                              | 0.48                                    | 0.52                               |
| <i>Accommodations, Eating and Drinking Services</i>                     | -13.33                         | -16.15                             | 13.55                                    | 17.11                              | 0.35                                    | 0.50                               |
| <i>Living-Related and Personal Services</i>                             | -11.37                         | -17.13                             | 12.72                                    | 17.50                              | 0.16                                    | 0.40                               |
| <i>Services for Amusement and Hobbies</i>                               | -8.82                          | -11.39                             | 13.44                                    | 15.96                              | 0.11                                    | 0.46                               |
| <i>Scientific Research, Professional and Technical Services</i>         | -7.58                          | -13.33                             | 8.90                                     | 15.38                              | 0.64                                    | 0.71                               |
| <i>Healthcare and Education</i>                                         | -5.71                          | -11.49                             | 11.69                                    | 16.47                              | 0.14                                    | 0.58                               |
| <i>Employment and Worker Dispatching Services</i>                       | -4.18                          | -6.27                              | 12.61                                    | 17.50                              | 0.54                                    | 0.41                               |
| <i>Other Service</i>                                                    | -9.99                          | -14.18                             | 8.58                                     | 13.82                              | 0.51                                    | 0.65                               |
| <i>Finance and Insurance</i>                                            | -                              | -                                  | -                                        | -                                  | -                                       | -                                  |

Table A7: Summary statistics about survey data (nominal output growth expectations)

| <i>Dataset: Annual Survey of Corporate Behavior; 33 industries; 2003-2021</i> |                            |                                      |                                     |
|-------------------------------------------------------------------------------|----------------------------|--------------------------------------|-------------------------------------|
| Sector                                                                        | (1) Historical<br>Averages | (2) Historical<br>standard deviation | (3) First-order<br>auto correlation |
| Foods                                                                         | 1.09                       | 0.74                                 | 0.41                                |
| Textiles & Apparels                                                           | 1.09                       | 0.76                                 | 0.28                                |
| Pulp & Paper                                                                  | 1.06                       | 0.99                                 | 0.37                                |
| Chemicals                                                                     | 1.18                       | 0.91                                 | 0.29                                |
| Pharmaceutical                                                                | 1.23                       | 0.69                                 | 0.54                                |
| Oil & Coal Products                                                           | 0.70                       | 1.16                                 | 0.26                                |
| Rubber Products                                                               | 0.99                       | 0.99                                 | -0.03                               |
| Glass & Ceramics Products                                                     | 1.02                       | 0.99                                 | 0.30                                |
| Iron & Steel                                                                  | 1.01                       | 0.94                                 | 0.35                                |
| Nonferrous Metals                                                             | 1.10                       | 0.90                                 | 0.35                                |
| Metal Products                                                                | 1.01                       | 0.80                                 | 0.48                                |
| Machinery                                                                     | 1.13                       | 0.88                                 | 0.44                                |
| Electric Appliances                                                           | 1.17                       | 0.89                                 | 0.46                                |
| Transportation Equipment                                                      | 1.08                       | 0.90                                 | 0.29                                |
| Precision Instruments                                                         | 1.24                       | 0.89                                 | 0.60                                |
| Other Products                                                                | 1.12                       | 0.81                                 | 0.52                                |
| Fishery, Agriculture & Forestry                                               | 0.74                       | 2.00                                 | 0.46                                |
| Mining                                                                        | 1.98                       | 0.41                                 | -0.39                               |
| Construction                                                                  | 1.17                       | 0.83                                 | 0.53                                |
| Wholesale Trade                                                               | 1.10                       | 0.86                                 | 0.39                                |
| Retail Trade                                                                  | 0.96                       | 0.81                                 | 0.50                                |
| Real Estate                                                                   | 1.11                       | 0.78                                 | 0.37                                |
| Land Transportation                                                           | 1.19                       | 0.81                                 | 0.58                                |
| Marine Transportation                                                         | 1.37                       | 0.81                                 | 0.67                                |
| Air Transportation                                                            | 0.67                       | 1.54                                 | 0.41                                |
| Warehousing & Harbor<br>Transportation Services                               | 1.20                       | 0.65                                 | 0.26                                |
| Information & Communication                                                   | 1.00                       | 0.84                                 | 0.16                                |
| Electric Power & Gas                                                          | 1.39                       | 1.09                                 | 0.29                                |
| Services                                                                      | 1.01                       | 0.76                                 | 0.45                                |
| Banks                                                                         | 1.29                       | 1.00                                 | 0.38                                |
| Securities & Commodity Futures                                                | 1.26                       | 1.16                                 | 0.33                                |
| Insurance                                                                     | 1.24                       | 1.30                                 | 0.47                                |
| Other Financing Businesses                                                    | 1.37                       | 0.85                                 | 0.35                                |

Table A8: Summary statistics about survey data (nominal sectoral demand growth expectations)

| <i>Dataset: Annual Survey of Corporate Behavior; 33 industries; 2003-2021</i> |                         |                                   |                                  |
|-------------------------------------------------------------------------------|-------------------------|-----------------------------------|----------------------------------|
| Sector                                                                        | (1) Historical averages | (2) Historical standard deviation | (3) First-order auto correlation |
| Foods                                                                         | 0.53                    | 0.51                              | 0.60                             |
| Textiles & Apparels                                                           | 0.39                    | 0.93                              | 0.15                             |
| Pulp & Paper                                                                  | -0.06                   | 1.68                              | 0.17                             |
| Chemicals                                                                     | 1.19                    | 1.05                              | 0.29                             |
| Pharmaceutical                                                                | 1.40                    | 0.57                              | -0.08                            |
| Oil & Coal Products                                                           | -1.02                   | 1.60                              | 0.32                             |
| Rubber Products                                                               | 0.85                    | 1.47                              | 0.14                             |
| Glass & Ceramics Products                                                     | 0.37                    | 1.14                              | 0.34                             |
| Iron & Steel                                                                  | 0.49                    | 2.39                              | 0.05                             |
| Nonferrous Metals                                                             | 1.04                    | 2.09                              | 0.25                             |
| Metal Products                                                                | 0.36                    | 1.32                              | 0.48                             |
| Machinery                                                                     | 1.27                    | 2.02                              | 0.00                             |
| Electric Appliances                                                           | 1.76                    | 1.27                              | 0.23                             |
| Transportation Equipment                                                      | 1.08                    | 2.00                              | 0.16                             |
| Precision Instruments                                                         | 1.51                    | 0.93                              | 0.23                             |
| Other Products                                                                | 0.55                    | 0.83                              | 0.44                             |
| Fishery, Agriculture & Forestry                                               | 1.20                    | 0.99                              | 0.52                             |
| Mining                                                                        | 1.81                    | 0.44                              | 0.16                             |
| Construction                                                                  | -0.16                   | 1.57                              | 0.56                             |
| Wholesale Trade                                                               | 0.77                    | 1.02                              | 0.43                             |
| Retail Trade                                                                  | 0.34                    | 0.92                              | 0.72                             |
| Real Estate                                                                   | 1.55                    | 1.59                              | 0.18                             |
| Land Transportation                                                           | 0.42                    | 0.69                              | 0.84                             |
| Marine Transportation                                                         | 2.14                    | 1.59                              | 0.01                             |
| Air Transportation                                                            | 1.34                    | 0.80                              | -0.27                            |
| Warehousing & Harbor Transportation Services                                  | 0.96                    | 0.65                              | 0.46                             |
| Information & Communication                                                   | 1.75                    | 1.29                              | 0.36                             |
| Electric Power & Gas                                                          | 1.42                    | 0.92                              | 0.10                             |
| Services                                                                      | 1.47                    | 1.25                              | 0.45                             |
| Banks                                                                         | 0.91                    | 0.68                              | 0.19                             |
| Securities & Commodity Futures                                                | 2.22                    | 2.94                              | 0.50                             |
| Insurance                                                                     | 1.00                    | 1.36                              | 0.83                             |
| Other Financing Businesses                                                    | 0.58                    | 2.62                              | 0.50                             |

Table A9: Summary statistics about sales data

| <i>Dataset: Financial statement statistics of corporations by industry, 29 sectors; 1975/3Q-2022/4Q</i> |                                |                                          |                                         |
|---------------------------------------------------------------------------------------------------------|--------------------------------|------------------------------------------|-----------------------------------------|
| <i>Sector</i>                                                                                           | <i>(1) Historical averages</i> | <i>(2) Historical standard deviation</i> | <i>(3) First-order auto correlation</i> |
| Foods                                                                                                   | 0.58                           | 3.93                                     | -0.19                                   |
| Textiles                                                                                                | -0.05                          | 7.33                                     | -0.11                                   |
| Wood Products                                                                                           | 0.21                           | 10.42                                    | -0.09                                   |
| Pulp and Paper                                                                                          | 0.34                           | 6.15                                     | 0.02                                    |
| Printing                                                                                                | 0.33                           | 7.21                                     | -0.09                                   |
| Chemicals                                                                                               | 0.64                           | 4.01                                     | 0.15                                    |
| Oil and Coal Products                                                                                   | 0.25                           | 9.60                                     | 0.05                                    |
| Glass and Ceramics Products                                                                             | 0.35                           | 5.13                                     | -0.10                                   |
| Iron and Steel                                                                                          | 0.39                           | 5.64                                     | 0.25                                    |
| Nonferrous Metals                                                                                       | 0.78                           | 6.55                                     | 0.28                                    |
| Metal Product                                                                                           | 0.70                           | 6.54                                     | -0.03                                   |
| Machinery                                                                                               | 0.87                           | 4.62                                     | 0.14                                    |
| Electric Device                                                                                         | 0.94                           | 4.64                                     | 0.23                                    |
| Cars and Related Products                                                                               | 1.03                           | 6.96                                     | -0.03                                   |
| Other Transportation Equipment                                                                          | 0.22                           | 9.26                                     | -0.23                                   |
| Other Products                                                                                          | 0.87                           | 7.30                                     | -0.22                                   |
| Mining                                                                                                  | 0.33                           | 11.46                                    | -0.15                                   |
| Construction                                                                                            | 0.82                           | 3.51                                     | -0.02                                   |
| Electric Power                                                                                          | 1.20                           | 5.08                                     | -0.05                                   |
| Gas and Water Supply                                                                                    | 1.25                           | 4.29                                     | 0.36                                    |
| Information and Communication                                                                           | 1.71                           | 4.95                                     | -0.03                                   |
| Land Transportation                                                                                     | 0.95                           | 5.18                                     | -0.04                                   |
| Water Transportation                                                                                    | 0.29                           | 6.12                                     | 0.12                                    |
| Wholesale                                                                                               | 0.39                           | 4.23                                     | 0.01                                    |
| Retail                                                                                                  | 1.24                           | 3.91                                     | 0.06                                    |
| Real Estate                                                                                             | 1.13                           | 9.10                                     | -0.16                                   |
| Hotel                                                                                                   | 0.69                           | 13.19                                    | -0.16                                   |
| Living-Related Service                                                                                  | 1.30                           | 12.41                                    | -0.07                                   |
| Other Service                                                                                           | 1.59                           | 10.06                                    | -0.29                                   |

## H Extracting the Sequence of Shocks on Aggregate and Sector-Specific Components of Demand

To extract the sequence of shocks on aggregate and sector-specific components of demand  $(e_t, \{\epsilon_t(i)\}_{i=1}^{29})$ , we decompose fluctuations in aggregate and sector-specific components (i.e.,  $u_t, \{\tilde{x}_t(i) - u_t\}_{i=1}^{29}$ ) into expected component and shocks for firms using the equations (4) and (5) and (6). More concretely, we use equation (4) that characterizes the law of motion of aggregate demand as:

$$u_t = \rho_u u_{t-1} + e_t,$$

to decompose aggregate demand into the expected component ( $\mathbb{E}_{t-1}[u_t] = \rho_u u_{t-1}$ ) and shock ( $e_t$ ). We estimate the parameter  $\rho_u$  and the unobservable shock  $e_t$  using the equation:

$$u_t = c_u + \rho_u u_{t-1} + e_t,$$

where  $c_u$  is a constant term that normalizes  $e_t$  to have mean zero. We then proxy the shock to aggregate demand as:

$$\hat{e}_t = u_t - \hat{c}_u - \hat{\rho}_u u_{t-1},$$

and the variance of the shock  $\sigma_t^2 = \mathbb{V}(e_t) = \mathbb{E}[e_t^2]$  is approximated by  $\frac{1}{2k+1} \sum_{s=-k}^k \hat{e}_t^2$ .

Similarly, we use equation (5) that characterizes the law of motion of sector-specific demand ( $\{\tilde{v}_t(i)\}_{i=1}^{29}$ ) as:

$$\tilde{v}_t(i) = v_t(i) - v_{t-1}(i) = \rho_v (v_{t-1}(i) - v_{t-2}(i)) + \epsilon_t(i) - \epsilon_{t-1}(i) = \rho_v \tilde{v}_{t-1}(i) + \epsilon_t(i) - \epsilon_{t-1}(i),$$

to decompose sector-specific demand into the expected component ( $\mathbb{E}_{t-1}[\tilde{v}_t(i)] = \rho_v \tilde{v}_{t-1}(i) - \epsilon_{t-1}(i)$ ) and shock ( $\epsilon_t(i)$ ). Since  $(\rho_v, \epsilon_t(i), \epsilon_{t-1}(i))$  are unobservable for us, we estimate them from following empirical equation to obtain  $(\rho_v, \epsilon_t(i) - \epsilon_{t-1}(i))$  :

$$(\tilde{x}_t(i) - u_t) = c_v(i) + \rho_v (\tilde{x}_{t-1}(i) - u_{t-1}) + (\epsilon_t(i) - \epsilon_{t-1}(i)),$$

where  $c_v(i)$  is a constant term to normalize  $\epsilon_t(i) - \epsilon_{t-1}(i)$  as mean zero. We then obtain

$$\hat{e}_t(i) - \hat{e}_{t-1}(i) = (\tilde{x}_t(i) - u_t) - \hat{c}_v(i) - \rho_v (\tilde{x}_{t-1}(i) - u_{t-1})$$

as the proxy for shock on sector-specific demand  $(\epsilon_t(i) - \epsilon_{t-1}(i))$ . Using the cross-sectional variation of  $\hat{e}_t(i) - \hat{e}_{t-1}(i)$ , we approximate



$$\tau_t^2 = \mathbb{V}(\epsilon_t(i)) = \mathbb{E}[\epsilon_t^2(i)] \text{ by } \frac{1}{2k+1} \sum_{s=-k}^k \left( \frac{1}{29} \sum_{i=1}^{29} \frac{(\hat{\epsilon}_t(i) - \hat{\epsilon}_{t-1}(i))^2}{2} \right).^{40}$$

Table A10: Summary statistics about aggregate and sector-specific components of demand

| <i>Dataset: Financial statement statistics of corporations by industry, 29 sectors; 1975/4Q-2022/4Q</i> |                                         |                                               |                                         |                                               |                                         |                                               |                               |                                  |
|---------------------------------------------------------------------------------------------------------|-----------------------------------------|-----------------------------------------------|-----------------------------------------|-----------------------------------------------|-----------------------------------------|-----------------------------------------------|-------------------------------|----------------------------------|
| Sector                                                                                                  | Historical averages                     |                                               | Historical standard deviation           |                                               | First-order auto correlation            |                                               | Historical standard deviation |                                  |
|                                                                                                         | (1)<br>Growth of<br>aggregate<br>demand | (2)<br>Growth of<br>sector-specific<br>demand | (3)<br>Growth of<br>aggregate<br>demand | (4)<br>Growth of<br>sector-specific<br>demand | (5)<br>Growth of<br>aggregate<br>demand | (6)<br>Growth of<br>sector-specific<br>demand | (7)<br>Aggregate<br>shocks    | (8)<br>Sector-specific<br>shocks |
| Foods                                                                                                   |                                         | -0.11                                         |                                         | 4.31                                          |                                         | -0.02                                         |                               | 4.32                             |
| Textiles                                                                                                |                                         | -0.74                                         |                                         | 6.54                                          |                                         | -0.15                                         |                               | 6.48                             |
| Wood Products                                                                                           |                                         | -0.48                                         |                                         | 10.12                                         |                                         | -0.15                                         |                               | 10.03                            |
| Pulp and Paper                                                                                          |                                         | -0.36                                         |                                         | 5.91                                          |                                         | 0.00                                          |                               | 5.92                             |
| Printing                                                                                                |                                         | -0.36                                         |                                         | 7.00                                          |                                         | -0.06                                         |                               | 6.99                             |
| Chemicals                                                                                               |                                         | -0.05                                         |                                         | 3.08                                          |                                         | -0.08                                         |                               | 3.07                             |
| Oil and Coal Products                                                                                   |                                         | -0.44                                         |                                         | 8.42                                          |                                         | -0.13                                         |                               | 8.37                             |
| Glass and Ceramics Products                                                                             |                                         | -0.34                                         |                                         | 4.91                                          |                                         | -0.17                                         |                               | 4.86                             |
| Iron and Steel                                                                                          |                                         | -0.30                                         |                                         | 4.16                                          |                                         | 0.06                                          |                               | 4.15                             |
| Nonferrous Metals                                                                                       |                                         | 0.09                                          |                                         | 4.88                                          |                                         | 0.12                                          |                               | 4.85                             |
| Metal Product                                                                                           |                                         | 0.01                                          |                                         | 6.18                                          |                                         | -0.15                                         |                               | 6.12                             |
| Machinery                                                                                               |                                         | 0.18                                          |                                         | 3.85                                          |                                         | -0.19                                         |                               | 3.79                             |
| Electric Device                                                                                         |                                         | 0.25                                          |                                         | 3.53                                          |                                         | -0.05                                         |                               | 3.53                             |
| Cars and Related Products                                                                               |                                         | 0.34                                          |                                         | 5.26                                          |                                         | -0.13                                         |                               | 5.23                             |
| Other Transportation Equipment                                                                          | 0.69                                    | -0.47                                         | 3.12                                    | 9.38                                          | 0.33                                    | -0.22                                         | 2.95                          | 9.16                             |
| Other Products                                                                                          |                                         | 0.18                                          |                                         | 6.53                                          |                                         | -0.27                                         |                               | 6.30                             |
| Mining                                                                                                  |                                         | -0.36                                         |                                         | 10.11                                         |                                         | -0.25                                         |                               | 9.80                             |
| Construction                                                                                            |                                         | 0.12                                          |                                         | 4.07                                          |                                         | 0.04                                          |                               | 4.04                             |
| Electric Power                                                                                          |                                         | 0.51                                          |                                         | 5.40                                          |                                         | -0.09                                         |                               | 5.38                             |
| Gas and Water Supply                                                                                    |                                         | 0.56                                          |                                         | 4.65                                          |                                         | 0.17                                          |                               | 4.58                             |
| Information and Communication                                                                           |                                         | 1.02                                          |                                         | 5.17                                          |                                         | -0.06                                         |                               | 5.17                             |
| Land Transportation                                                                                     |                                         | 0.26                                          |                                         | 5.40                                          |                                         | -0.09                                         |                               | 5.39                             |
| Water Transportation                                                                                    |                                         | -0.40                                         |                                         | 5.02                                          |                                         | -0.06                                         |                               | 5.02                             |
| Whole-sale                                                                                              |                                         | -0.30                                         |                                         | 3.16                                          |                                         | -0.23                                         |                               | 3.07                             |
| Retail                                                                                                  |                                         | 0.55                                          |                                         | 4.22                                          |                                         | 0.07                                          |                               | 4.21                             |
| Real Estate                                                                                             |                                         | 0.44                                          |                                         | 8.60                                          |                                         | -0.11                                         |                               | 8.57                             |
| Hotel                                                                                                   |                                         | -0.01                                         |                                         | 12.10                                         |                                         | -0.15                                         |                               | 12.00                            |
| Living-Related Service                                                                                  |                                         | 0.61                                          |                                         | 11.85                                         |                                         | -0.09                                         |                               | 11.83                            |
| Other Service.                                                                                          |                                         | 0.90                                          |                                         | 9.84                                          |                                         | -0.29                                         |                               | 9.43                             |

Table A10 reports summary statistics for estimates of the aggregate and sector-specific components of demand  $(u_t, \{\tilde{x}_t(i) - u_t\}_{i=1}^{29})$  for the average (columns 1 and 2), standard deviation (columns 3 and 4), and first-order autocorrelation (columns 5 and 6) of the series. Columns (7) and (8) report standard deviation of  $\hat{\epsilon}_t$  and  $\{\hat{\epsilon}_t(i)\}_{i=1}^{29}$ , respectively.

## I Aggregate Demand and the Output Gap

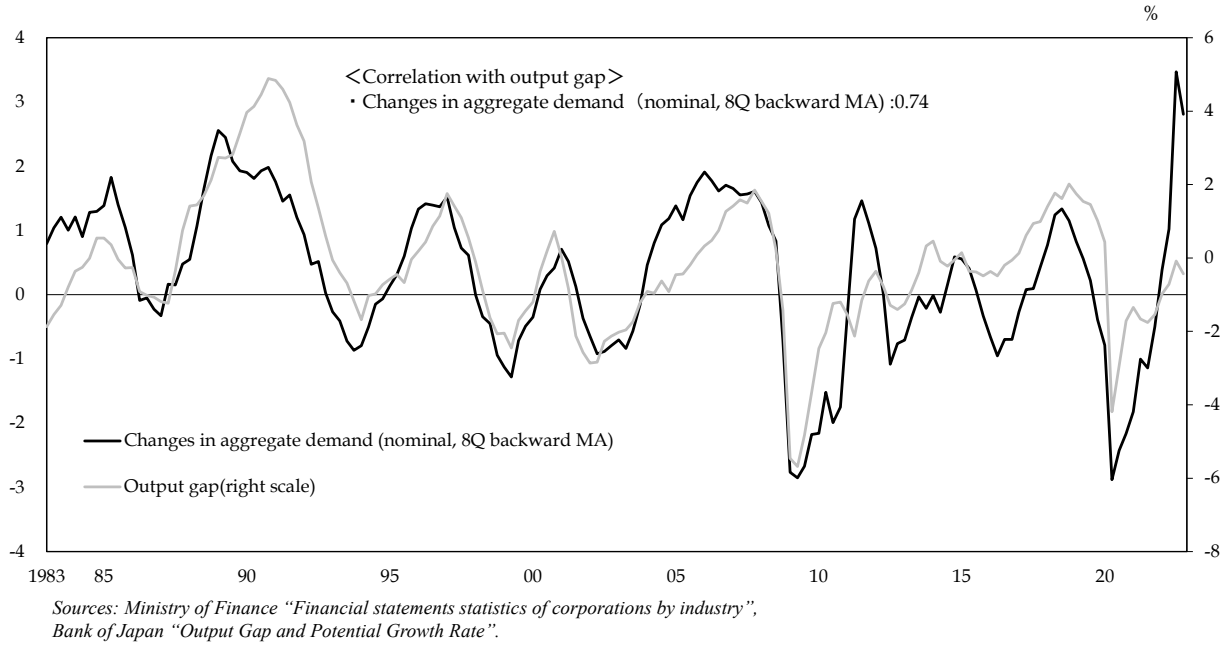
To evaluate whether the extracted changes in aggregate demand  $(u_t = (\sum_{i=1}^{29} \Lambda_i)^{-1} \sum_{i=1}^{29} \Lambda_i \tilde{x}_t(i))$  is a plausible measure of aggregate disturbances, and it is consistent with alternative measures, we compare the eight-quarters backward moving averages of the changes in aggregate

<sup>40</sup>Note that the following equation holds,

$$\begin{aligned} \mathbb{V}(\hat{\epsilon}_t(i) - \hat{\epsilon}_{t-1}(i)) &= \mathbb{E}[(\hat{\epsilon}_t(i) - \hat{\epsilon}_{t-1}(i))^2] = 2\mathbb{V}(\epsilon_t(i)) \\ &\Leftrightarrow \mathbb{V}(\epsilon_t(i)) = \frac{1}{2}\mathbb{V}(\epsilon_t(i) - \epsilon_{t-1}(i)), \end{aligned}$$

and thus the variance of  $\epsilon_t(i) - \epsilon_{t-1}(i)$  is monotonically increasing in  $\tau_t^2$ .

Figure A1: Changes in aggregate demand and output gap



demand,  $\frac{1}{8} \sum_{s=0}^7 u_{t-s}$ ,<sup>41</sup> with the output gap published by the Bank of Japan.<sup>42</sup>

Figure A1 examines the relation between the dynamics of our estimates for aggregate shocks and the output gaps. It shows that our measure of changes in aggregate demand highly co-moves with the averages of changes in sectoral demand across sectors, with a correlation coefficient equal to 0.74, suggesting that our identified measure for the changes in aggregate demand is consistent with alternative measures of the changes in aggregate demand.

## J Producer Price Index Data

We use monthly data on sector-level producer prices of Japanese firms from the corporate Goods Price Index (CGPI), compiled by the Bank of Japan. The data cover the period from 1961:M1 for 23 major sectors in the economy. The data are transformed to quarterly data by taking averages of samples in each quarter (i.e., three months) and matched with the

<sup>41</sup>Our measure of the changes in aggregate demand is a flow rather than stock concept. By comparing moving averages of the changes in aggregate demand (i.e., the averages of flow data) with the output gap (i.e. stock data), we ensure that our measure is consistent with conventional measures.

<sup>42</sup>The series is available here. [https://www.boj.or.jp/en/research/research\\_data/gap/index.htm/](https://www.boj.or.jp/en/research/research_data/gap/index.htm/)  
The description of the methodology for the estimation is here [https://www.boj.or.jp/en/research/brp/ron\\_2017/ron170531a.htm/](https://www.boj.or.jp/en/research/brp/ron_2017/ron170531a.htm/).

database for industry-level sales data. Table A11 shows summary statistics of the sectoral inflation.

Table A11: Descriptive statistics about PPI data

| <i>Dataset: producer price index (seasonally adjusted, QoQ), 23sectors; 1976/1Q-2022/4Q</i> |                                |                                          |                                         |
|---------------------------------------------------------------------------------------------|--------------------------------|------------------------------------------|-----------------------------------------|
| <i>Sector</i>                                                                               | <i>(1) Historical averages</i> | <i>(2) Historical standard deviation</i> | <i>(3) First-order auto correlation</i> |
| Foods                                                                                       | 0.33                           | 0.78                                     | 0.58                                    |
| Textiles & Apparels                                                                         | 0.15                           | 1.04                                     | 0.43                                    |
| Wood Products                                                                               | 0.56                           | 3.53                                     | 0.51                                    |
| Pulp and Paper                                                                              | 0.31                           | 1.83                                     | 0.64                                    |
| Chemicals                                                                                   | 0.11                           | 1.90                                     | 0.53                                    |
| Oil and Coal Products                                                                       | 0.76                           | 6.89                                     | 0.29                                    |
| Glass and Ceramics Products                                                                 | 0.35                           | 1.04                                     | 0.63                                    |
| Iron and Steel                                                                              | 0.54                           | 2.41                                     | 0.70                                    |
| Nonferrous Metals                                                                           | 0.43                           | 4.19                                     | 0.49                                    |
| Metal Product                                                                               | 0.37                           | 0.93                                     | 0.63                                    |
| Machinery                                                                                   | 0.21                           | 0.58                                     | 0.41                                    |
| Electric Device                                                                             | -0.11                          | 0.63                                     | 0.52                                    |
| Transportation Equipment                                                                    | -0.04                          | 0.51                                     | 0.33                                    |
| Mining and Quarrying of Stone and Gravel                                                    | 0.58                           | 1.85                                     | 0.66                                    |
| Construction                                                                                | 0.34                           | 1.06                                     | 0.41                                    |
| Electricity                                                                                 | 0.45                           | 4.20                                     | 0.26                                    |
| Gas, Heat supply and Water                                                                  | 0.61                           | 5.70                                     | 0.51                                    |
| Information and Communications                                                              | -0.19                          | 0.64                                     | 0.23                                    |
| Land Transportation                                                                         | 0.20                           | 0.60                                     | 0.44                                    |
| Water Transportation                                                                        | 0.13                           | 2.61                                     | 0.32                                    |
| Real Estate                                                                                 | 0.19                           | 0.89                                     | 0.43                                    |
| Accommodations, Eating and Drinking Services                                                | -0.17                          | 4.23                                     | 0.31                                    |
| Living-Related and Personal Services                                                        | -0.01                          | 0.58                                     | 0.25                                    |

Note: The classification of the sectors in PPI data for Japan are matched with those from the sectoral sales data in Table A9.

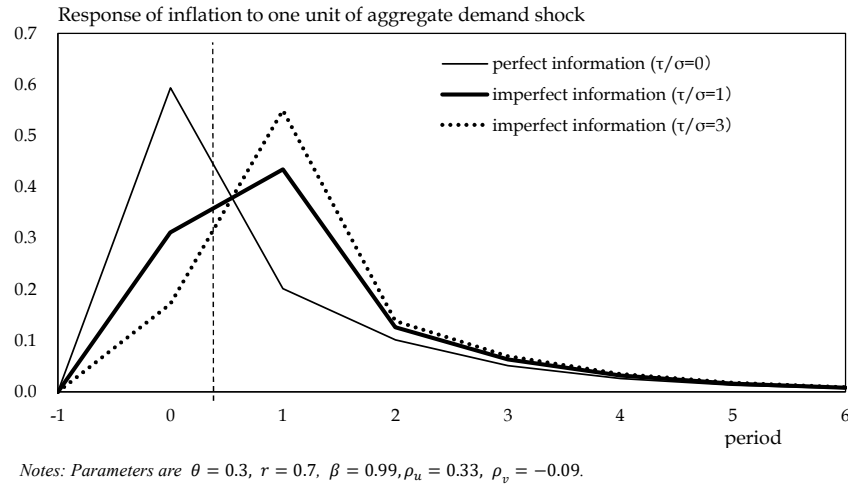
## K IRF of Aggregate Inflation to Aggregate Demand Shocks

### K.1 Numerical Assessment

How does the relative volatility of sector-specific demand shocks to aggregate shocks influence the sensitivity of inflation to changes in aggregate demand? To address this central question of our analysis, we simulate the model and determine the response of inflation to a one-period, positive aggregate demand shock for different values of  $\tau_t/\sigma_t$ . Figure A2 shows that an increase in the ratio  $\tau_t/\sigma_t$  reduces the response of inflation to changes in aggregate demand. Since the firm cannot disentangle changes in aggregate and sector-specific demand, it attributes changes in total sectoral demand partially to changes in sector-specific demand,

which have no effect on the price-setting decisions of firms in other sectors in the economy. Attributing part of the movement in total sectoral demand to sector-specific demand induces the firm to decrease the response of prices to aggregate shocks. Therefore, inflation becomes less responsive to changes in total sectoral demand. If the ratio of  $\tau_t/\sigma_t$  is large, the firm conjectures that a large fraction of the changes in total sectoral demand occurs because of sector-specific shock. Consequently, the firm expects that the average price in the period remains almost the same as that in the previous period and adjusts its prices less strongly to changes in aggregate demand. This makes the response more persistent.

Figure A2: Impulse response functions of aggregate inflation to aggregate shocks



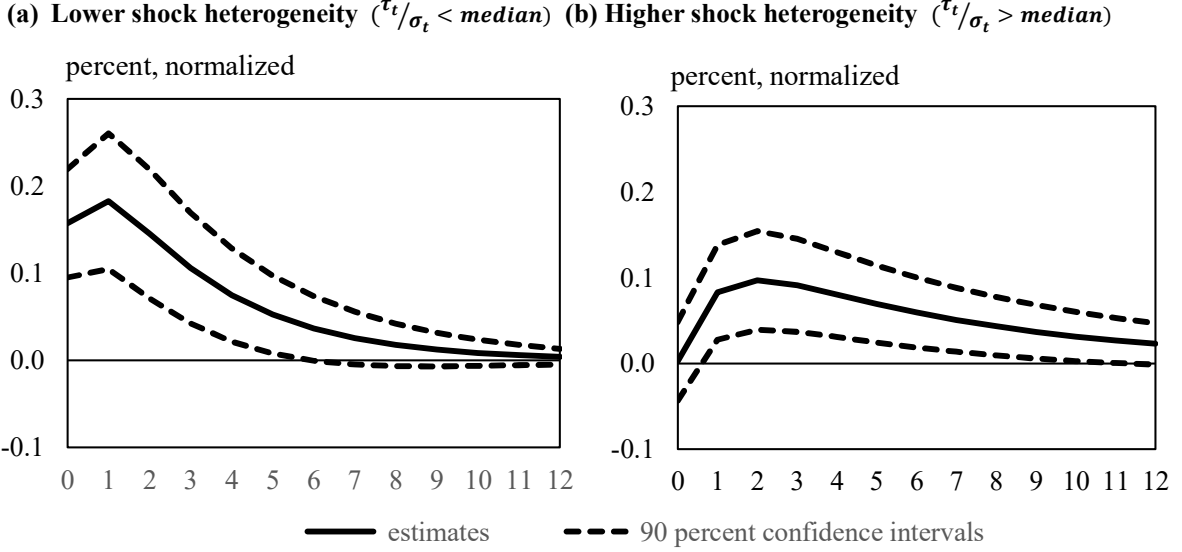
## K.2 Empirical Assessment

As shown in Figure A2, in a reduced form the response of the aggregate inflation to aggregate demand shocks becomes more persistent as the shock heterogeneity  $\tau_t/\sigma_t$  increases. In what follows, we investigate the difference in the dynamics responses of aggregate inflation to changes in aggregate demand. Specifically, we estimate the following Vector Auto-Regression model by dividing the samples to two groups,  $\tau_t/\sigma_t < \text{median}$  with 94 samples and  $\tau_t/\sigma_t > \text{median}$  with 95 samples. Due to the limited sample size, a lag length of one was adopted in order to avoid over-parameterization in the VAR model.

$$A_0 \begin{bmatrix} \Delta \text{demand}_t \\ \text{CPI}_t \end{bmatrix} = C + A_1 \begin{bmatrix} \Delta \text{demand}_{t-1} \\ \text{CPI sales}_{t-1} \end{bmatrix} + \begin{bmatrix} \epsilon_{\text{demand}_t} \\ \epsilon_{\text{CPI-specific}_t} \end{bmatrix}$$

where the matrix  $A_0$  is lower triangular, the vector  $C$  is of constant terms, the matrix  $A_1$  is for the lag term, and  $\epsilon_{\text{aggregate}_t}$  and  $\epsilon_{\text{CPI-specific}_t}(i)$  are the exogenous aggregate and sector-specific shocks, respectively.

Figure A3: Responses of inflation to aggregate shocks



*Note: Response to one standard deviation shock (the response in the initial period is normalized as one). Bold lines indicate the estimates and dotted lines indicate the 90 percent confidence intervals. The series for the core consumer price index is “all items, less fresh food (impact of consumption taxes are adjusted)”. Sample period is 1975Q4-2022Q4 (the number of observations for panel (a) is 94 and that for panel (b) is 95). Shocks are identified by Cholesky decomposition with the assumption that aggregate shock is faster than inflation specific shocks. Due to the limited sample size, a lag length of one was adopted in order to avoid over-parameterization in the VAR model.*

Figure A3 shows the impulse responses of the inflation to aggregate shocks based on the estimated VAR model. The comparison of panels (a) and (b) shows the relationship that the response under lower shock heterogeneity exhibits lower persistence than that under higher shock heterogeneity in two aspects. First, the response in panel (a) is positive and significant for up to five quarters, whereas the response in panel (b) remains significant for up to eleven quarters. Second, the peak of the response occurs one quarter later in panel (a), whereas in panel (b) the peak occurs two quarters later.

## L Sensitivity of Sectoral Inflation to Sector-Specific Demand under Common Shock Heterogeneity

This appendix assesses the empirical validity of our model concerning sectoral inflation dynamics by assuming common shock heterogeneity across all firms. To this end,  $\tau$  in Figure

2 is used, rather than  $\tau(i)$  in Figure A4, to construct the proxy for shock heterogeneity in estimating equation (N.1).

Table A12: Estimation of the sectoral inflation dynamics

| <i>Dataset: Financial statement statistics of corporations by industry, producer price index; 23 sectors; 1976/1Q-2022/4Q</i> |                             |                             |                             |
|-------------------------------------------------------------------------------------------------------------------------------|-----------------------------|-----------------------------|-----------------------------|
| <i>Dependent Variable: sectoral of inflation rate (<math>\pi_t(i)</math>, seasonally adjusted, QoQ)</i>                       |                             |                             |                             |
|                                                                                                                               | <i>(i) two quarters</i>     | <i>(ii) four quarters</i>   | <i>(iii) eight quarters</i> |
| <i>Changes in sector-specific demand (<math>\hat{v}_t(i)</math>)</i>                                                          | 0.18 ***<br>(0.05)          | 0.19 ***<br>(0.05)          | 0.20 ***<br>(0.06)          |
| <i>Changes in sector-specific demand×time dummy (2000-2022) (<math>\hat{v}_t(i) \times \mathbf{1}_{\{2000-2022\}}</math>)</i> | -0.004<br>(0.03)            | -0.008<br>(0.02)            | -0.002<br>(0.0)             |
| <b><i>Changes in sector-specific demand ×shock heterogeneity (<math>\hat{v}_t(i) \times \tau_t/\sigma_t</math>)</i></b>       | <b>-0.02 ***</b><br>(0.006) | <b>-0.02 ***</b><br>(0.007) | <b>-0.03 ***</b><br>(0.008) |
| <i>Observations</i>                                                                                                           | 3,897                       | 3,897                       | 3,897                       |
| <i>Adjusted-R<sup>2</sup></i>                                                                                                 | 0.27                        | 0.26                        | 0.26                        |

*Note: Estimated by ordinary-least-squares with fixed- and time-effect models. The standard errors are cross-section (sector) cluster robust standard errors. First lag of sector-specific demand is included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity.*

*\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.*

Table A12 shows the estimates for equation (N.1) for alternative measures of shock heterogeneity based on time windows of two quarters (column 1), four quarters (columns 2), and eight quarters (column 3), respectively. All entries show that the sector-specific component of inflation is positively correlated with current sector-specific demand ( $x_t(i)$ ) at one percent significant level. Important for our analysis, the interaction term between sector-specific demand and the degree of shock heterogeneity ( $x_t(i) \times \tau_t/\sigma_t$ ) is negative and significant in all entries.

To ensure that the inclusion of the time dummy is not driving the significance of the negative relation between  $\tau_t(i)/\sigma_t$  and inflation, Table A13 presents results for the benchmark regression that abstracts from the indicator variable  $\mathbf{1}_{\{2000-2022\}}$  by omitting the interaction term between past inflation and the indicator variable (i.e.,  $\pi_{t-1} \times \mathbf{1}_{\{2000-2022\}}$ ) and the interaction term between changes in demand and the indicator variable ( $x_t(i) \times \mathbf{1}_{\{2000-2022\}}$ ) from equation (N.1). The regression coefficient on the term  $x_t(i) \times (\tau_t/\sigma_t)$  (bold entry) remains significant and negative, as in the benchmark regression.

## M Sensitivity of Sectoral Inflation to Total Sectoral Demand

This appendix assesses the empirical validity of our model from the perspective of total fluctuation of sectoral inflation dynamics. Equation (31) shows that the sensitivity of the

Table A13: Estimation of the sectoral inflation dynamics

| <i>Dataset: Financial statement statistics of corporations by industry, producer price index; 23 sectors; 1976/1Q-2022/4Q</i> |                             |                             |                             |
|-------------------------------------------------------------------------------------------------------------------------------|-----------------------------|-----------------------------|-----------------------------|
| <i>Dependent Variable: sectoral inflation rate (<math>\pi_t(i)</math>), seasonally adjusted, QoQ)</i>                         |                             |                             |                             |
|                                                                                                                               | (i) two quarters            | (ii) four quarters          | (iii) eight quarters        |
| <i>Changes in sector-specific demand (<math>\hat{v}_t(i)</math>)</i>                                                          | 0.18 ***<br>(0.05)          | 0.18 ***<br>(0.05)          | 0.19 ***<br>(0.06)          |
| <b><i>Changes in sector-specific demand<br/>× shock heterogeneity (<math>\hat{v}_t(i) \times \tau_t/\sigma_t</math>)</i></b>  | <b>-0.02 ***<br/>(0.01)</b> | <b>-0.02 ***<br/>(0.01)</b> | <b>-0.03 ***<br/>(0.01)</b> |
| <i>Observations</i>                                                                                                           | 3,897                       | 3,897                       | 3,897                       |
| <i>Adjusted-R<sup>2</sup></i>                                                                                                 | 0.27                        | 0.26                        | 0.26                        |

Note: Estimated by ordinary-least-squares with fixed- and time-effect models. The standard errors are cross-section (sector) cluster robust standard errors. First lag of sector-specific demand is included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity.

\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.

sectoral inflation ( $\pi_t(i)$ ) to changes in total sectoral demand ( $x_t(i)$ ) depends on  $\alpha_2$ , which is negatively related to shock heterogeneity ( $\tau_t(i)/\sigma_t$ ). In what follows, we investigate whether the model predictions are supported in the data.

To estimate the relation between the degree of shock heterogeneity and the sensitivity of the sectoral inflation to total sectoral demand, we follow the insights from the theoretical model, encapsulated by equation (31), and construct a panel dataset for the sectoral inflation rates ( $\pi_t(i)$ ), total demand in each sector ( $x_t(i) \equiv u_t + \tilde{v}_t(i)$ ), and the measures for shock heterogeneity ( $\tau_t(i)/\sigma_t$ ) that is heterogeneous across sectors. We use measures for aggregate inflation  $\pi_t$ , quarterly changes in consumer price index from Japanese Statistics Bureau,  $u_t$ ,  $\tilde{v}_t(i)$  and  $\tau_t(i)/\sigma_t$  from the Financial Statements Statistics of Corporations by Industry prepared by the Ministry of Finance, and we measure sectoral inflation  $\pi_t(i)$  with the Producer Price index (PPI) in Japan, which is released by the Bank of Japan on a monthly basis.<sup>43</sup> The empirical specification of sectoral inflation equation is:

$$\pi_t(i) = d_1(i) + \underbrace{(d_2 + d_3 \mathbf{1}_{\{2000-2022\}} + d_4 (\tau_t(i)/\sigma_t))}_{\alpha_1} \pi_{t-1} + \underbrace{(d_5 + d_6 \mathbf{1}_{\{2000-2022\}} + d_7 (\tau_t(i)/\sigma_t))}_{\alpha_2} x_t(i) + d_8 u_{t-1} + d_9 u_{t-2} + d_{10} \tilde{v}_{t-1}(i) + \varepsilon_t^d, \quad (\text{M.1})$$

where  $d_1(i)$  is fixed-effect indicator variable, the parameters  $d_2$ - $d_{10}$  are regression coefficients,  $\mathbf{1}_{\{2000-2022\}}$  is an indicator variable equal to 1 for the period 2000-2022 to control for the years with exogenous fall in price stickiness, as in our benchmark specification, and  $\varepsilon_t^d$  is the error term.

<sup>43</sup>For details, see [https://www.boj.or.jp/en/statistics/pi/cgpi\\_release/index.htm/](https://www.boj.or.jp/en/statistics/pi/cgpi_release/index.htm/). For the summary statistics of the PPI data, see Appendix J.

Table A14: Estimation of the sectoral inflation dynamics

| <i>Dataset: Financial statement statistics of corporations by industry, producer price index; 23 sectors; 1976/1Q-2022/4Q</i> |                              |                              |                             |
|-------------------------------------------------------------------------------------------------------------------------------|------------------------------|------------------------------|-----------------------------|
| <i>Dependent Variable: sectoral inflation rate (<math>\pi_t(i)</math>, seasonally adjusted, QoQ)</i>                          |                              |                              |                             |
|                                                                                                                               | <i>(i) two quarters</i>      | <i>(ii) four quarters</i>    | <i>(iii) eight quarters</i> |
| <i>Lag of inflation (<math>\pi_{t-1}</math>)</i>                                                                              | 0.27 ***<br>(0.07)           | 0.23 ***<br>(0.07)           | 0.23 ***<br>(0.07)          |
| <i>Lag of inflation×time<br/>dummy (2000-2022) (<math>\pi_{t-1} \times 1_{\{2000-2022\}}</math>)</i>                          | 0.05<br>(0.16)               | 0.06<br>(0.16)               | 0.06<br>(0.17)              |
| <i>Lag of inflation×shock<br/>heterogeneity (<math>\pi_{t-1} \times \tau_t(i)/\sigma_t</math>)</i>                            | -0.004<br>(0.01)             | 0.007<br>(0.01)              | 0.007<br>(0.01)             |
| <i>Changes in total demand (<math>x_t(i)</math>)</i>                                                                          | 0.13 ***<br>(0.04)           | 0.13 ***<br>(0.04)           | 0.12 ***<br>(0.04)          |
| <i>Changes in total demand×time<br/>dummy (2000-2022) (<math>x_t(i) \times 1_{\{2000-2022\}}</math>)</i>                      | 0.01<br>(0.02)               | 0.01<br>(0.02)               | 0.02<br>(0.02)              |
| <b><i>Changes in total demand<br/>×shock heterogeneity (<math>x_t(i) \times \tau_t(i)/\sigma_t</math>)</i></b>                | <b>-0.01 ***<br/>(0.003)</b> | <b>-0.01 ***<br/>(0.003)</b> | <b>-0.01 **<br/>(0.004)</b> |
| <i>Observations</i>                                                                                                           | 3,874                        | 3,874                        | 3,874                       |
| <i>Adjusted-R<sup>2</sup></i>                                                                                                 | 0.33                         | 0.33                         | 0.33                        |

Note: Estimated by ordinary-least-squares with fixed- and time-effect models. The standard errors are cross-section (sector) cluster robust standard errors. First and second lags of changes in aggregate demand and the first lag of changes in sector-specific demand are included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity.

\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.

Table A14 shows the estimates for equation (M.1) for alternative measures of shock heterogeneity based on time windows of two quarters (column 1), four quarters (columns 2), and eight quarters (column 3), respectively. All entries show that the sector-specific component of inflation is positively correlated with current total demand ( $x_t(i)$ ). Important for our analysis, the interaction term between total sectoral demand and the degree of shock heterogeneity ( $x_t(i) \times \tau_t(i)/\sigma_t$ ) is negative and significant in all entries. Our results show that the data supports a decrease in the sensitivity of the sectoral inflation in response to a rise in shock heterogeneity, consistent with the prediction in our theoretical model.

To ensure that the inclusion of the time dummy is not driving the significance of the negative relation between  $\tau_t(i)/\sigma_t$  and inflation, Table A15 presents results for the benchmark regression that abstracts from the indicator variable  $1_{\{2000-2022\}}$  by omitting the interaction term between past inflation and the indicator variable (i.e.,  $\pi_{t-1} \times 1_{\{2000-2022\}}$ ) and the interaction term between changes in demand and the indicator variable ( $x_t(i) \times 1_{\{2000-2022\}}$ ) from equation (M.1). The regression coefficient on the term  $x_t(i) \times (\tau_t(i)/\sigma_t)$  (bold entry) remains significant and negative, as in the benchmark regression.

Finally, to consider the possibility that firms set prices flexibly, Table A16 shows results



for the benchmark regression that dropped lagged inflation ( $\pi_{t-1}$ ) from equation (M.1). The regression coefficient on the term  $x_t(i) \times (\tau_t(i)/\sigma_t)$  (bold entry) remains significant and negative, as in the benchmark regression. These estimation results confirm the theoretical prediction.

Table A15: Estimation of the sectoral inflation dynamics

| <i>Dataset: Financial statement statistics of corporations by industry, producer price index; 23 sectors; 1976/1Q-2022/4Q</i> |                            |                             |                            |
|-------------------------------------------------------------------------------------------------------------------------------|----------------------------|-----------------------------|----------------------------|
| <i>Dependent Variable: sectoral inflation rate (<math>\pi_t(i)</math>, seasonally adjusted, QoQ)</i>                          |                            |                             |                            |
|                                                                                                                               | (i) two quarters           | (ii) four quarters          | (iii) eight quarters       |
| Lag of inflation ( $\pi_{t-1}$ )                                                                                              | 0.31 ***<br>(0.09)         | 0.26 ***<br>(0.07)          | 0.27 ***<br>(0.08)         |
| Lag of inflation<br>× shock heterogeneity ( $\pi_{t-1} \times \tau_t(i)/\sigma_t$ )                                           | -0.01<br>(0.01)            | -0.01<br>(0.01)             | -0.01<br>(0.01)            |
| Changes in total demand ( $x_t(i)$ )                                                                                          | 0.14 ***<br>(0.05)         | 0.14 ***<br>(0.04)          | 0.13 ***<br>(0.04)         |
| <b>Changes in total demand<br/>× shock heterogeneity (<math>x_t(i) \times \tau_t(i)/\sigma_t</math>)</b>                      | <b>-0.01 **</b><br>(0.003) | <b>-0.01 ***</b><br>(0.003) | <b>-0.01 **</b><br>(0.004) |
| Observations                                                                                                                  | 3,874                      | 3,874                       | 3,874                      |
| Adjusted-R <sup>2</sup>                                                                                                       | 0.33                       | 0.33                        | 0.32                       |

Note: Estimated by ordinary-least-squares with fixed- and time-effect models. The standard errors are cross-section (sector) cluster robust standard errors. First and second lags of changes in aggregate demand and the first lag of changes in sector-specific demand are included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity.

\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.

Table A16: Estimation of the sectoral inflation dynamics

| <i>Dataset: Financial statement statistics of corporations by industry, producer price index; 23 sectors; 1976/1Q-2022/4Q</i> |                             |                             |                             |
|-------------------------------------------------------------------------------------------------------------------------------|-----------------------------|-----------------------------|-----------------------------|
| <i>Dependent Variable: sectoral inflation rate (<math>\pi_t(i)</math>, seasonally adjusted, QoQ)</i>                          |                             |                             |                             |
|                                                                                                                               | (i) two quarters            | (ii) four quarters          | (iii) eight quarters        |
| Changes in total demand ( $x_t(i)$ )                                                                                          | 0.17 ***<br>(0.05)          | 0.17 ***<br>(0.05)          | 0.17 ***<br>(0.05)          |
| <b>Changes in total demand<br/>× shock heterogeneity (<math>x_t(i) \times \tau_t(i)/\sigma_t</math>)</b>                      | <b>-0.01 ***</b><br>(0.004) | <b>-0.01 ***</b><br>(0.004) | <b>-0.01 ***</b><br>(0.005) |
| Observations                                                                                                                  | 3,883                       | 3,883                       | 3,883                       |
| Adjusted-R <sup>2</sup>                                                                                                       | 0.27                        | 0.27                        | 0.27                        |

Note: Estimated by ordinary-least-squares with fixed- and time-effect models. The standard errors are cross-section (sector) cluster robust standard errors. First and second lags of changes in aggregate demand and the first lag of changes in sector-specific demand are included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity.

\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.

## N Robustness for Sectoral Inflation Dynamics

In this Appendix, we further examine the validity of our theoretical framework using data on sectoral inflation in Japan.<sup>44</sup> Proposition 4 and Proposition 5 include theoretical prediction regarding sectoral price and sectoral inflation, which imply that sectoral shock heterogeneity ( $\tau_t/\sigma_t$ ) can affect sectoral price differently under imperfect information. We examine the plausibility of our theoretical framework by evaluating the empirical validity of these predictions using historical data of sectoral prices in Japan.

First, we estimate the ratio between the volatility of the sector-specific component and the aggregate component of demand for each sectors. While the model assumes homogeneous  $\tau_t$  across industries, this empirical analysis allows the possibility of heterogeneous  $\tau_t$ .<sup>45</sup> We then test the empirical relevance of the increases in the relative volatility of sector-specific shocks for the reduced sensitivity of sectoral inflation to changes in sector-specific demand.

**Estimation of  $\tau_t(i)/\sigma_t$ .** To estimate the proxy for the shock heterogeneity in each sector, i.e. the ratio  $\tau_t(i)/\sigma_t$ , we follow the methodology in the previous section except that we do not take averages across sectors in equation (36) so that we can estimate heterogeneous  $\tau_t(i)$ .<sup>46</sup> We also normalize the series in each sector in order that the series has mean zero and the standard deviation is one. To match the data on shock heterogeneity with the sectoral inflation, we consider series for 23 industries.

Figure A4 shows the median of the 23 estimated series for the ratio of the variance of sector-specific shocks to the variance of aggregate shocks ( $\tau_t(i)/\sigma_t$ ) for the alternative time windows: two quarters ( $k = 1$ ), four quarters ( $k = 2$ ), and eight quarters ( $k = 4$ ). Similar to the developments in figure 2, entries show that the ratio  $\tau_t(i)/\sigma_t$  substantially varies throughout the sample period.

---

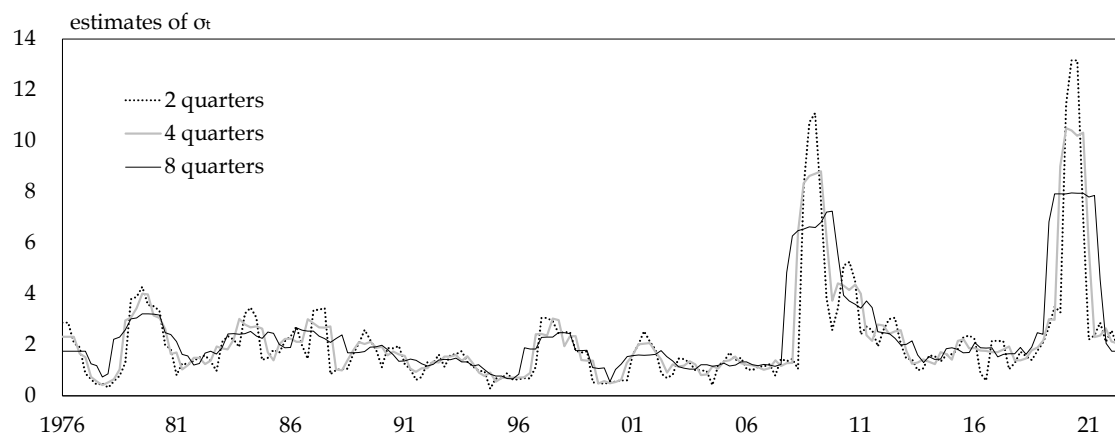
<sup>44</sup>Empirical literature on sectoral inflation under imperfect information is highly limited. For example, Mackowiak et al. (2009b) find that sectoral prices respond immediately to sector-specific shocks, whereas their response to aggregate shocks is gradual, and they further demonstrate that rational inattention models can broadly match it. Kato and Okuda (2017) and Kato et al. (2021) find that sectoral inflation persistence decreases with market concentration and demonstrate that this fact can be reconciled by dispersed information models. Okuda and Tsuruga (2025) indicate that the degree of fragmentation of information about sectoral costs within each sector plays a crucial role in explaining empirical facts about Japanese firms' pricing behaviors. This study examines the implications of across-sector heterogeneity of shocks for sectoral inflation dynamics.

<sup>45</sup>For robustness, Appendix L conducts the same analysis assuming common shock heterogeneity across sectors ( $\tau(i) = \tau$ )

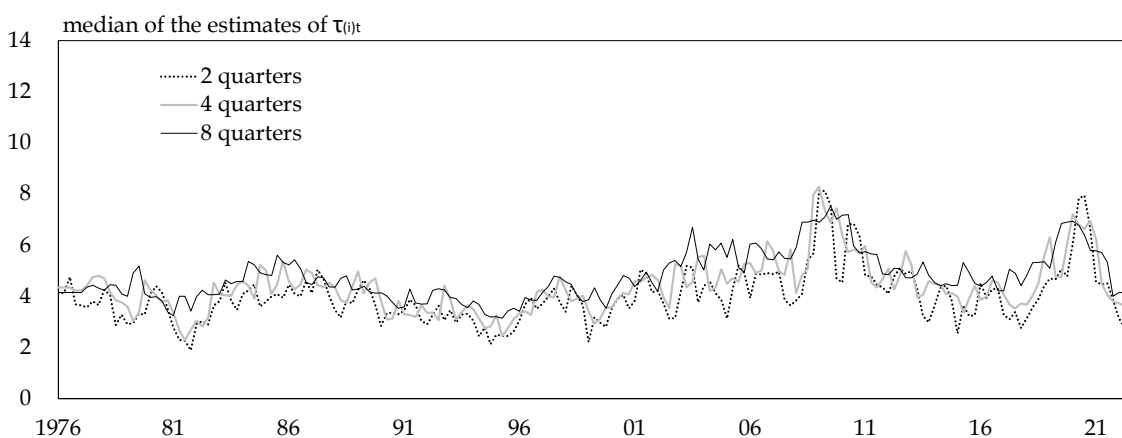
<sup>46</sup>Namely,  $\tau_t^2(i) = \frac{1}{2k+1} \sum_{s=-k}^k \frac{(\hat{\epsilon}_{t-s} - \hat{\epsilon}_{t-s-1})^2}{2}$ .

Figure A4: Median of estimated shock heterogeneity in each sector ( $\tau_t(i)/\sigma_t$ )

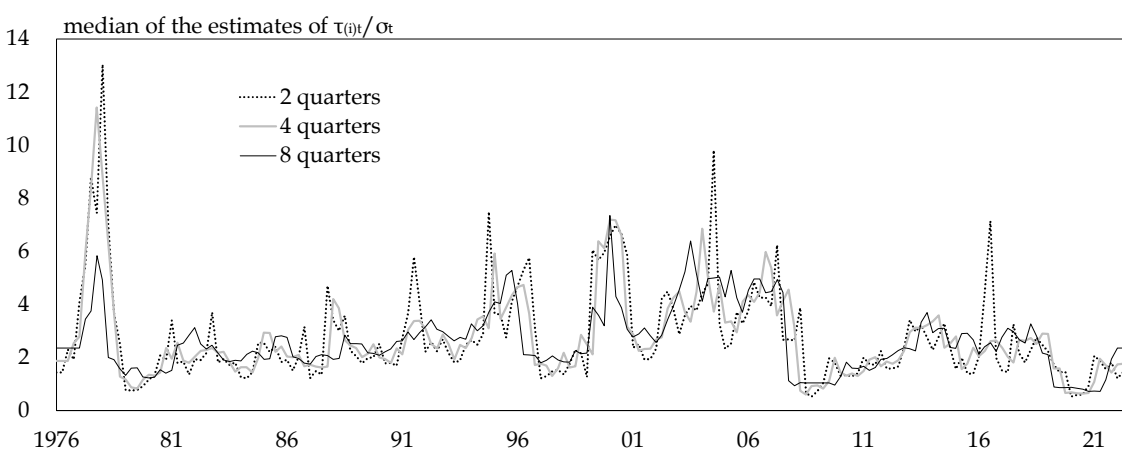
**(a) Standard deviation of aggregate shocks**



**(b) Standard deviation of sector-specific shocks**



**(c) Shock heterogeneity**



Source: Ministry of Finance "Financial statements statistics of corporations by industry".

**Sensitivity of Sectoral Inflation to Sector-specific Demand.** Equation (31) shows that the sensitivity of the sectoral inflation ( $\pi_t(i)$ ) to changes in sector-specific demand ( $\tilde{v}_t(i)$ ) depends on  $\alpha_2$ , which is negatively related to shock heterogeneity ( $\tau_t(i)/\sigma_t$ ) as shown in section 4.1. In what follows, we investigate whether the model predictions are supported in the data.

To estimate the relation between the degree of shock heterogeneity and the sensitivity of the sectoral inflation to sector-specific demand, we follow the insights from the theoretical model, encapsulated by equation (31), and construct a panel dataset for the sectoral inflation rates ( $\pi_t(i)$ ), sector-specific demand in each sector ( $\tilde{v}_t(i)$ ), and the measures for shock heterogeneity ( $\tau_t(i)/\sigma_t$ ) that is heterogeneous across sectors. We use measures for aggregate inflation  $\pi_t$ , quarterly changes in consumer price index from Japanese Statistics Bureau,  $\tilde{v}_t(i)$  and  $\tau_t(i)/\sigma_t$  from the Financial Statements Statistics of Corporations by Industry prepared by the Ministry of Finance, and we measure sectoral inflation  $\pi_t(i)$  with the Producer Price index (PPI) in Japan, which is released by the Bank of Japan on a monthly basis.<sup>47</sup>

$$\pi_t(i) - \pi_t = d_1(i) + \underbrace{(d_2 + d_3 \mathbf{1}_{\{2000-2022\}} + d_4 (\tau_t(i)/\sigma_t))}_{\alpha_2} \tilde{v}_t(i) + d_5 \tilde{v}_{t-1}(i) + \varepsilon_t^d, \quad (\text{N.1})$$

where  $d_1(i)$  is fixed effect indicator variable, parameters  $(d_2, \dots, d_5)$  are regression coefficients,  $\mathbf{1}_{\{2000-2022\}}$  is an indicator variable equal to 1 for the period 2000-2022 to control for the years with exogenous fall in price stickiness, as in our benchmark specification, and  $\varepsilon_t^d$  is the error term.

Table A17 shows the estimates for equation (N.1) for alternative measures of shock heterogeneity based on time windows of two quarters (column 1), four quarters (columns 2), and eight quarters (column 3), respectively. All entries show that sectoral inflation is positively correlated with current sector-specific demand ( $\tilde{v}_t(i)$ ). Important for our analysis, the interaction term between sector-specific demand and the degree of shock heterogeneity ( $\tilde{v}_t(i) \times \tau_t(i)/\sigma_t$ ) is negative and significant in all entries. Our results show that the data support a decrease in the sensitivity of sectoral inflation in response to a rise in shock heterogeneity, consistent with the prediction in our theoretical model.<sup>48</sup>

<sup>47</sup>For details, see [https://www.boj.or.jp/en/statistics/pi/cgpi\\_release/index.htm/](https://www.boj.or.jp/en/statistics/pi/cgpi_release/index.htm/). For the summary statistics of the PPI data, see Appendix J.

<sup>48</sup>Appendix L confirms that this relationship continues to be observed if shock heterogeneity is assumed to be common across sectors ( $\tau(i) = \tau$ ).

Table A17: Estimation of the sectoral inflation dynamics

| <i>Dataset: Financial statement statistics of corporations by industry, producer price index; 23 sectors; 1976/1Q-2022/4Q</i>  |                             |                             |                             |
|--------------------------------------------------------------------------------------------------------------------------------|-----------------------------|-----------------------------|-----------------------------|
| <i>Dependent Variable: sectoral of inflation rate (<math>\pi_t(i)</math>, seasonally adjusted, QoQ)</i>                        |                             |                             |                             |
|                                                                                                                                | <i>(i) two quarters</i>     | <i>(ii) four quarters</i>   | <i>(iii) eight quarters</i> |
| <i>Changes in sector-specific demand (<math>\hat{v}_t(i)</math>)</i>                                                           | 0.17 ***<br>(0.05)          | 0.18 ***<br>(0.05)          | 0.17 ***<br>(0.05)          |
| <i>Changes in sector-specific demand (<math>\hat{v}_t(i)</math>)<br/>×time dummy (2000-2022)</i>                               | -0.005<br>(0.03)            | -0.01<br>(0.03)             | -0.005<br>(0.03)            |
| <b><i>Changes in sector-specific demand<br/>×shock heterogeneity (<math>\hat{v}_t(i) \times \tau_t(i)/\sigma_t</math>)</i></b> | <b>-0.01 ***</b><br>(0.004) | <b>-0.01 ***</b><br>(0.004) | <b>-0.01 ***</b><br>(0.005) |
| <i>Observations</i>                                                                                                            | 3,897                       | 3,897                       | 3,897                       |
| <i>Adjusted-R<sup>2</sup></i>                                                                                                  | 0.27                        | 0.27                        | 0.27                        |

*Note: Estimated by ordinary-least-squares with fixed- and time-effect models. The standard errors are cross-section (sector) cluster robust standard errors. First lag of sector-specific demand is included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity.*

*\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.*

Figure A5 compares the estimates for the coefficient  $d_4$  on the interaction term ( $\tilde{v}_t(i) \times \tau_t/\sigma_t$ ) for the alternative time windows of two, four, and eight quarters for the computation of the variance (dark diamond) against the coefficient  $\alpha_2$  on the interaction term  $\tilde{v}_t(i) \times \tau_t/\sigma_t$  in equation (30), which represents the theoretical interaction between shock heterogeneity and sector-specific demand (white diamond).<sup>49</sup> The bands for the dark diamond show 90 percent confidence intervals of the empirical estimates. The figure shows that the estimates from the data are remarkably close to those generated by the theoretical model, and our theoretical framework is consistent with the estimates in the data.

Finally, to ensure the robustness of significance of the negative relation between  $\tau_t(i)/\sigma_t$  and sectoral inflation, Table A18 presents results for the benchmark regression in equation (N.1) without the interaction term between past inflation and the indicator variable (i.e.,  $\pi_{t-1} \times \mathbf{1}_{\{2000-2022\}}$ ) and the interaction term between changes in demand and the indicator variable ( $\tilde{v}_t(i) \times \mathbf{1}_{2000-2022}$ ). The regression coefficient on the term  $\tilde{v}_t(i) \times (\tau_t(i)/\sigma_t)$  (bold entry) remains significant and negative, as in the benchmark regression.<sup>50</sup> Note that this equation also corresponds to equation 33 for the case of flexible prices.

Our findings indicate that imperfect information regarding sectoral demand, coupled with shifts in shock heterogeneity, has played a role in the time-varying response of inflation

<sup>49</sup>The theoretical prediction is calculated as the changes in  $\alpha_2$  consistent with changes in  $\tau_t/\sigma_t$  from 2.5 to 4.5, divided by the changes in  $\tau_t/\sigma_t$  (i.e. 4.5-2.5=2) under the same calibration of Figure 1.

<sup>50</sup>Appendix M examines the sensitivity of sectoral inflation to changes in total sectoral demand using the same dataset. The estimation results confirm the theoretical prediction.

Figure A5: Shock heterogeneity and sensitivity of inflation to changes in sector-specific demand

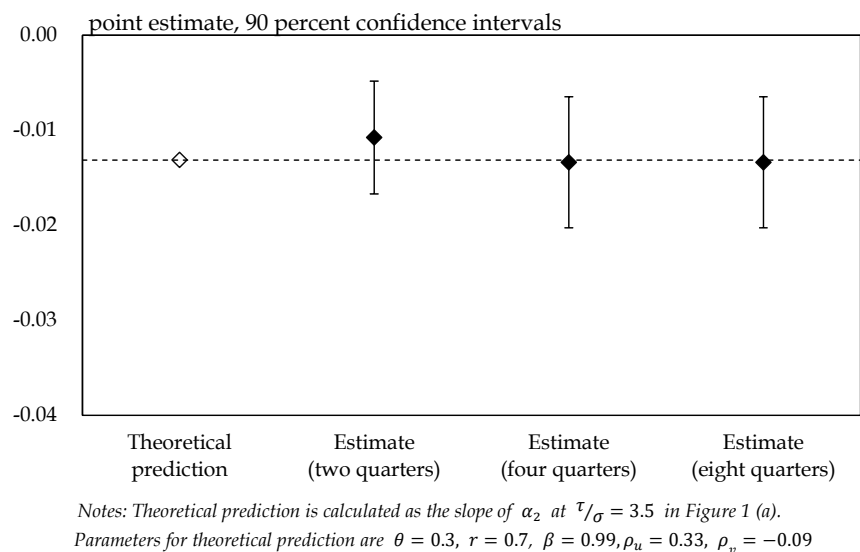


Table A18: Estimation of the sectoral inflation dynamics

| <i>Dataset: Financial statement statistics of corporations by industry, producer price index; 23 sectors; 1976/1Q-2022/4Q</i>   |                              |                              |                              |
|---------------------------------------------------------------------------------------------------------------------------------|------------------------------|------------------------------|------------------------------|
| <i>Dependent Variable: sectoral inflation rate (<math>\pi_t(i)</math>), seasonally adjusted, QoQ)</i>                           |                              |                              |                              |
|                                                                                                                                 | <i>(i) two quarters</i>      | <i>(ii) four quarters</i>    | <i>(iii) eight quarters</i>  |
| <i>Changes in sector-specific demand (<math>\hat{v}_t(i)</math>)</i>                                                            | 0.17 ***<br>(0.05)           | 0.17 ***<br>(0.05)           | 0.17 ***<br>(0.05)           |
| <b><i>Changes in sector-specific demand<br/>× shock heterogeneity (<math>\hat{v}_t(i) \times \tau_t(i)/\sigma_v</math>)</i></b> | <b>-0.01 ***<br/>(0.004)</b> | <b>-0.01 ***<br/>(0.004)</b> | <b>-0.01 ***<br/>(0.005)</b> |
| <i>Observations</i>                                                                                                             | 3,897                        | 3,897                        | 3,897                        |
| <i>Adjusted-R<sup>2</sup></i>                                                                                                   | 0.27                         | 0.27                         | 0.27                         |

Note: Estimated by ordinary-least-squares with fixed- and time-effect models. The standard errors are cross-section (sector) cluster robust standard errors. First lag of sector-specific demand is included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity.

\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.

to sector-specific demand shocks in Japan. Appendix O also shows that all results in this section remain broadly intact if we exclude the samples since the Covid-19 pandemic.

## O Robustness of the Regression Results

The estimation results in the main text and Appendix M cover 1976-2022 as samples. This Appendix examines the robustness of the results if we exclude the period of Covid-19 pandemic from the samples, given that the nature of business cycles and inflation environments during the pandemic was critically different from standard ones. Specifically, regarding aggregate inflation dynamics, Tables A19 and A20 are, respectively, the counterparts of Tables 4 and 5, and Table A21 corresponds with Table 6.

Moreover, in terms of sectoral inflation dynamics, Table A22 is the counterpart of Table A12 and A23 corresponds with Table A13. Then, Table A24 is the counterpart of Table A14, and A25 and A26, respectively, correspond to Tables A15 and A16. Finally, Table A27 is the counterpart of Table A17 and A28 corresponds with Table A18. Importantly, the estimation results of these Tables remain broadly unchanged if samples during the Covid-19 pandemic are excluded.

Table A19: Estimation of aggregate inflation dynamics: before the pandemic

| <i>Dataset: Financial statement statistics of corporations by industry, consumer price index; 29 sectors; 1976/2Q-2019/4Q</i> |                             |                             |                             |
|-------------------------------------------------------------------------------------------------------------------------------|-----------------------------|-----------------------------|-----------------------------|
| <i>Dependent Variable: Inflation rate (<math>\pi_t</math>, core consumer price index, seasonally adjusted, QoQ)</i>           |                             |                             |                             |
|                                                                                                                               | (i) two quarters            | (ii) four quarters          | (iii) eight quarters        |
| Constant                                                                                                                      | 0.05 **<br>(0.03)           | 0.05 **<br>(0.03)           | 0.04<br>(0.03)              |
| Lag of inflation ( $\pi_{t-1}$ )                                                                                              | 0.68 ***<br>(0.12)          | 0.67 ***<br>(0.13)          | 0.67 ***<br>(0.18)          |
| Lag of inflation×time dummy (2000-2019)<br>( $\pi_{t-1} \times 1_{\{2000-2019\}}$ )                                           | -0.25<br>(0.16)             | -0.25<br>(0.16)             | -0.24<br>(0.17)             |
| Lag of inflation<br>×shock heterogeneity ( $\pi_{t-1} \times \tau_t/\sigma_t$ )                                               | 0.01<br>(0.01)              | 0.02<br>(0.01)              | 0.02<br>(0.03)              |
| Changes in aggregate demand ( $u_t$ )                                                                                         | 0.09 ***<br>(0.03)          | 0.10 ***<br>(0.03)          | 0.11 ***<br>(0.03)          |
| Changes in aggregate demand ×time<br>dummy (2000-2019) ( $u_t \times 1_{\{2000-2019\}}$ )                                     | -0.01<br>(0.03)             | -0.01<br>(0.03)             | -0.02<br>(0.03)             |
| <b>Changes in aggregate demand<br/>×shock heterogeneity (<math>u_t \times \tau_t/\sigma_t</math>)</b>                         | <b>-0.02 ***<br/>(0.01)</b> | <b>-0.02 ***<br/>(0.01)</b> | <b>-0.02 ***<br/>(0.01)</b> |
| Observations                                                                                                                  | 176                         | 176                         | 176                         |
| Adjusted-R <sup>2</sup>                                                                                                       | 0.77                        | 0.77                        | 0.77                        |

Note: Estimated by ordinary-least-squares. The standard errors are HAC estimators. First and second lags of changes in aggregate demand are included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity. The series for the core consumer price index is “all items, less fresh food (impact of consumption taxes are adjusted)”.

\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.

Table A20: Estimation of aggregate inflation dynamics: before the pandemic

| <i>Dataset: Financial statement statistics of corporations by industry, consumer price index; 29 sectors; 1976/2Q-2019/4Q</i> |                             |                             |                             |
|-------------------------------------------------------------------------------------------------------------------------------|-----------------------------|-----------------------------|-----------------------------|
| <i>Dependent Variable: Inflation rate (<math>\pi_t</math>, core consumer price index, seasonally adjusted, QoQ)</i>           |                             |                             |                             |
|                                                                                                                               | (i) two quarters            | (ii) four quarters          | (iii) eight quarters        |
| Constant                                                                                                                      | 0.06 ***<br>(0.02)          | 0.06 **<br>(0.02)           | 0.05 **<br>(0.02)           |
| Lag of inflation ( $\pi_{t-1}$ )                                                                                              | 0.71 ***<br>(0.11)          | 0.71 ***<br>(0.12)          | 0.69 ***<br>(0.18)          |
| Lag of inflation<br>×shock heterogeneity ( $\pi_{t-1} \times \tau_t/\sigma_t$ )                                               | 0.01<br>(0.01)              | 0.01<br>(0.01)              | 0.02<br>(0.04)              |
| Changes in aggregate demand ( $u_t$ )                                                                                         | 0.09 ***<br>(0.02)          | 0.10 ***<br>(0.03)          | 0.11 ***<br>(0.03)          |
| <b>Changes in aggregate demand<br/>×shock heterogeneity (<math>u_t \times \tau_t/\sigma_t</math>)</b>                         | <b>-0.02 ***<br/>(0.01)</b> | <b>-0.02 ***<br/>(0.01)</b> | <b>-0.03 ***<br/>(0.01)</b> |
| Observations                                                                                                                  | 176                         | 176                         | 176                         |
| Adjusted-R <sup>2</sup>                                                                                                       | 0.75                        | 0.75                        | 0.75                        |

Note: Estimated by ordinary-least-squares. The standard errors are HAC estimators. First and second lags of changes in aggregate demand are included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity. The series for the core consumer price index is “all items, less fresh food (impact of consumption taxes are adjusted)”.

\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.



Table A21: Estimation of aggregate inflation dynamics: before the pandemic

| <i>Dataset: Financial statement statistics of corporations by industry, consumer price index; 29 sectors; 1976/2Q-2019/4Q</i> |                           |                           |                           |
|-------------------------------------------------------------------------------------------------------------------------------|---------------------------|---------------------------|---------------------------|
| <i>Dependent Variable: Inflation rate (<math>\pi_t</math>, core consumer price index, seasonally adjusted, QoQ)</i>           |                           |                           |                           |
|                                                                                                                               | (i) two quarters          | (ii) four quarters        | (iii) eight quarters      |
| Constant                                                                                                                      | 0.25 ***<br>(0.04)        | 0.23 ***<br>(0.04)        | 0.23 ***<br>(0.04)        |
| Changes in aggregate demand ( $u_t$ )                                                                                         | 0.10 ***<br>(0.03)        | 0.10 ***<br>(0.03)        | 0.11 ***<br>(0.03)        |
| <b>Changes in aggregate demand<br/>×shock heterogeneity (<math>u_t \times \tau_t/\sigma_t</math>)</b>                         | <b>-0.02 **</b><br>(0.01) | <b>-0.02 **</b><br>(0.01) | <b>-0.02 **</b><br>(0.01) |
| Observations                                                                                                                  | 176                       | 176                       | 176                       |
| Adjusted-R <sup>2</sup>                                                                                                       | 0.29                      | 0.28                      | 0.28                      |

Note: Estimated by ordinary-least-squares. The standard errors are HAC estimators. First and second lags of changes in aggregate demand are included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity. The series for the core consumer price index is "all items, less fresh food (impact of consumption taxes are adjusted)".

\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.

Table A22: Estimation of sectoral inflation dynamics: before the pandemic

| <i>Dataset: Financial statement statistics of corporations by industry, producer price index; 23 sectors; 1976/1Q-2019/4Q</i> |                           |                           |                            |
|-------------------------------------------------------------------------------------------------------------------------------|---------------------------|---------------------------|----------------------------|
| <i>Dependent Variable: sectoral inflation rate (<math>\pi_t(i)</math>, seasonally adjusted, QoQ)</i>                          |                           |                           |                            |
|                                                                                                                               | (i) two quarters          | (ii) four quarters        | (iii) eight quarters       |
| Changes in sector-specific demand ( $\hat{v}_t(i)$ )                                                                          | 0.18 ***<br>(0.06)        | 0.19 ***<br>(0.06)        | 0.20 ***<br>(0.07)         |
| Changes in sector-specific demand×time<br>dummy (2000-2019) ( $\hat{v}_t(i) \times 1_{\{2000-2019\}}$ )                       | -0.01<br>(0.02)           | -0.01<br>(0.02)           | -0.01<br>(0.02)            |
| <b>Changes in sector-specific demand<br/>×shock heterogeneity (<math>\hat{v}_t(i) \times \tau_t/\sigma_t</math>)</b>          | <b>-0.02 **</b><br>(0.01) | <b>-0.02 **</b><br>(0.01) | <b>-0.03 ***</b><br>(0.01) |
| Observations                                                                                                                  | 3,621                     | 3,621                     | 3,621                      |
| Adjusted-R <sup>2</sup>                                                                                                       | 0.26                      | 0.25                      | 0.26                       |

Note: Estimated by ordinary-least-squares with fixed- and time-effect models. The standard errors are cross-section (sector) cluster robust standard errors. First lag of sector-specific demand is included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity.

\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.

Table A23: Estimation of sectoral inflation dynamics: before the pandemic

| <i>Dataset: Financial statement statistics of corporations by industry, producer price index; 23 sectors; 1976/1Q-2019/4Q</i> |                             |                            |                             |
|-------------------------------------------------------------------------------------------------------------------------------|-----------------------------|----------------------------|-----------------------------|
| <i>Dependent Variable: sectoral inflation rate (<math>\pi_t(i)</math>, seasonally adjusted, QoQ)</i>                          |                             |                            |                             |
|                                                                                                                               | (i) two quarters            | (ii) four quarters         | (iii) eight quarters        |
| <i>Changes in sector-specific demand (<math>\hat{v}_t(i)</math>)</i>                                                          | 0.18 ***<br>(0.07)          | 0.18 ***<br>(0.07)         | 0.20 ***<br>(0.07)          |
| <b><i>Changes in sector-specific demand<br/>× shock heterogeneity (<math>\hat{v}_t(i) \times \tau_t/\sigma_t</math>)</i></b>  | <b>-0.02 ***<br/>(0.01)</b> | <b>-0.02 ***<br/>(0.0)</b> | <b>-0.03 ***<br/>(0.01)</b> |
| <i>Observations</i>                                                                                                           | 3,621                       | 3,621                      | 3,621                       |
| <i>Adjusted-R<sup>2</sup></i>                                                                                                 | 0.26                        | 0.25                       | 0.26                        |

Note: Estimated by ordinary-least-squares with fixed- and time-effect models. The standard errors are cross-section (sector) cluster robust standard errors. First lag of sector-specific demand is included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity.

\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.

Table A24: Estimation of sectoral inflation dynamics: before the pandemic

| <i>Dataset: Financial statement statistics of corporations by industry, producer price index; 23 sectors; 1976/1Q-2019/4Q</i> |                             |                              |                              |
|-------------------------------------------------------------------------------------------------------------------------------|-----------------------------|------------------------------|------------------------------|
| <i>Dependent Variable: sectoral inflation rate (<math>\pi_t(i)</math>, seasonally adjusted, QoQ)</i>                          |                             |                              |                              |
|                                                                                                                               | (i) two quarters            | (ii) four quarters           | (iii) eight quarters         |
| <i>Lag of inflation (<math>\pi_{t-1}</math>)</i>                                                                              | 0.29 ***<br>(0.08)          | 0.26 ***<br>(0.08)           | 0.28 ***<br>(0.08)           |
| <i>Lag of inflation×time<br/>dummy (2000-2019) (<math>\pi_{t-1} \times 1_{\{2000-2019\}}</math>)</i>                          | 0.07<br>(0.12)              | 0.08<br>(0.12)               | 0.08<br>(0.12)               |
| <i>Lag of inflation<br/>× shock heterogeneity (<math>\pi_{t-1} \times \tau_t(i)/\sigma_t</math>)</i>                          | -0.01<br>(0.01)             | -0.002<br>(0.01)             | -0.01<br>(0.01)              |
| <i>Changes in total demand (<math>x_t(i)</math>)</i>                                                                          | 0.13 ***<br>(0.04)          | 0.13 ***<br>(0.04)           | 0.12 ***<br>(0.04)           |
| <i>Changes in total demand×time<br/>dummy (2000-2019) (<math>x_t(i) \times 1_{\{2000-2019\}}</math>)</i>                      | 0.005<br>(0.02)             | 0.001<br>(0.02)              | 0.002<br>(0.02)              |
| <b><i>Changes in total demand<br/>× shock heterogeneity (<math>x_t(i) \times \tau_t(i)/\sigma_t</math>)</i></b>               | <b>-0.01 **<br/>(0.003)</b> | <b>-0.01 ***<br/>(0.003)</b> | <b>-0.01 ***<br/>(0.003)</b> |
| <i>Observations</i>                                                                                                           | 3,598                       | 3,598                        | 3,598                        |
| <i>Adjusted-R<sup>2</sup></i>                                                                                                 | 0.33                        | 0.33                         | 0.33                         |

Note: Estimated by ordinary-least-squares with fixed- and time-effect models. The standard errors are cross-section (sector) cluster robust standard errors. First and second lags of changes in aggregate demand and the first lag of changes in sector-specific demand are included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity.

\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.

Table A25: Estimation of sectoral inflation dynamics: before the pandemic

| <i>Dataset: Financial statement statistics of corporations by industry, producer price index; 23 sectors; 1976/1Q-2019/4Q</i> |                                   |                                    |                                    |
|-------------------------------------------------------------------------------------------------------------------------------|-----------------------------------|------------------------------------|------------------------------------|
| <i>Dependent Variable: sectoral inflation rate (<math>\pi_t(i)</math>), seasonally adjusted, QoQ)</i>                         |                                   |                                    |                                    |
|                                                                                                                               | <i>(i) two quarters</i>           | <i>(ii) four quarters</i>          | <i>(iii) eight quarters</i>        |
| <i>Lag of inflation (<math>\pi_{t-1}</math>)</i>                                                                              | 0.34 ***<br>(0.04)                | 0.31 ***<br>(0.04)                 | 0.32 ***<br>(0.05)                 |
| <i>Lag of inflation</i><br><i>×shock heterogeneity (<math>\pi_{t-1} \times 1_{\{2000-2019\}}</math>)</i>                      | -0.01 *<br>(0.01)                 | -0.002<br>(0.01)                   | -0.01<br>(0.01)                    |
| <i>Changes in total demand (<math>x_t(i)</math>)</i>                                                                          | 0.13 **<br>(0.05)                 | 0.13 **<br>(0.05)                  | 0.12 **<br>(0.04)                  |
| <b><i>Changes in total demand</i></b><br><b><i>×shock heterogeneity (<math>x_t(i) \times \tau_t(i)/\sigma_t</math>)</i></b>   | <b>-0.01 **</b><br><b>(0.003)</b> | <b>-0.01 ***</b><br><b>(0.003)</b> | <b>-0.01 ***</b><br><b>(0.003)</b> |
| <i>Observations</i>                                                                                                           | 3,598                             | 3,598                              | 3,598                              |
| <i>Adjusted-R<sup>2</sup></i>                                                                                                 | 0.33                              | 0.33                               | 0.32                               |

Note: Estimated by ordinary-least-squares with fixed- and time-effect models. The standard errors are cross-section (sector) cluster robust standard errors. First and second lags of changes in aggregate demand and the first lag of changes in sector-specific demand are included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity.

\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.

Table A26: Estimation of sectoral inflation dynamics: before the pandemic

| <i>Dataset: Financial statement statistics of corporations by industry, producer price index; 23 sectors; 1976/1Q-2019/4Q</i> |                                    |                                    |                                    |
|-------------------------------------------------------------------------------------------------------------------------------|------------------------------------|------------------------------------|------------------------------------|
| <i>Dependent Variable: sectoral inflation rate (<math>\pi_t(i)</math>), seasonally adjusted, QoQ)</i>                         |                                    |                                    |                                    |
|                                                                                                                               | <i>(i) two quarters</i>            | <i>(ii) four quarters</i>          | <i>(iii) eight quarters</i>        |
| <i>Changes in total demand (<math>x_t(i)</math>)</i>                                                                          | 0.16 ***<br>(0.06)                 | 0.16 ***<br>(0.05)                 | 0.16 ***<br>(0.05)                 |
| <b><i>Changes in total demand</i></b><br><b><i>×shock heterogeneity (<math>x_t(i) \times \tau_t(i)/\sigma_t</math>)</i></b>   | <b>-0.01 ***</b><br><b>(0.004)</b> | <b>-0.01 ***</b><br><b>(0.004)</b> | <b>-0.01 ***</b><br><b>(0.004)</b> |
| <i>Observations</i>                                                                                                           | 3,607                              | 3,607                              | 3,607                              |
| <i>Adjusted-R<sup>2</sup></i>                                                                                                 | 0.27                               | 0.26                               | 0.26                               |

Note: Estimated by ordinary-least-squares with fixed- and time-effect models. The standard errors are cross-section (sector) cluster robust standard errors. First and second lags of changes in aggregate demand and the first lag of changes in sector-specific demand are included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity.

\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level. \* Significant at the 10 percent level.

Table A27: Estimation of sectoral inflation dynamics: before the pandemic

| <i>Dataset: Financial statement statistics of corporations by industry, producer price index; 23 sectors; 1976/1Q-2019/4Q</i> |                              |                              |                             |
|-------------------------------------------------------------------------------------------------------------------------------|------------------------------|------------------------------|-----------------------------|
| <i>Dependent Variable: sectoral inflation rate (<math>\pi_t(i)</math>, seasonally adjusted, QoQ)</i>                          |                              |                              |                             |
|                                                                                                                               | <i>(i) two quarters</i>      | <i>(ii) four quarters</i>    | <i>(iii) eight quarters</i> |
| <i>Changes in sector-specific demand (<math>\hat{v}_t(i)</math>)</i>                                                          | 0.17 ***<br>(0.05)           | 0.17 ***<br>(0.05)           | 0.17 ***<br>(0.05)          |
| <i>Changes in sector-specific demand×time dummy (2000-2019) (<math>\hat{v}_t(i) \times 1_{\{2000-2019\}}</math>)</i>          | -0.01<br>(0.02)              | -0.02<br>(0.02)              | -0.02<br>(0.03)             |
| <b><i>Changes in sector-specific demand ×shock heterogeneity (<math>\hat{v}_t(i) \times \tau_t/\sigma_t</math>)</i></b>       | <b>-0.01 ***<br/>(0.004)</b> | <b>-0.01 ***<br/>(0.004)</b> | <b>-0.01 ***<br/>(0.01)</b> |
| <i>Observations</i>                                                                                                           | 3,621                        | 3,621                        | 3,621                       |
| <i>Adjusted-R<sup>2</sup></i>                                                                                                 | 0.26                         | 0.26                         | 0.26                        |

Note: Estimated by ordinary-least-squares with fixed- and time-effect models. The standard errors are cross-section (sector) cluster robust standard errors. First lag of sector-specific demand is included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity.

\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level.\* Significant at the 10 percent level.

Table A28: Estimation of sectoral inflation dynamics: before the pandemic

| <i>Dataset: Financial statement statistics of corporations by industry, producer price index; 23 sectors; 1976/1Q-2019/4Q</i> |                              |                              |                              |
|-------------------------------------------------------------------------------------------------------------------------------|------------------------------|------------------------------|------------------------------|
| <i>Dependent Variable: sectoral inflation rate (<math>\pi_t(i)</math>, seasonally adjusted, QoQ)</i>                          |                              |                              |                              |
|                                                                                                                               | <i>(i) two quarters</i>      | <i>(ii) four quarters</i>    | <i>(iii) eight quarters</i>  |
| <i>Changes in sector-specific demand (<math>\hat{v}_t(i)</math>)</i>                                                          | 0.16 **<br>(0.06)            | 0.16 ***<br>(0.06)           | 0.16 ***<br>(0.05)           |
| <b><i>Changes in sector-specific demand ×shock heterogeneity (<math>\hat{v}_t(i) \times \tau_t/\sigma_t</math>)</i></b>       | <b>-0.01 ***<br/>(0.004)</b> | <b>-0.01 ***<br/>(0.004)</b> | <b>-0.01 ***<br/>(0.005)</b> |
| <i>Observations</i>                                                                                                           | 3,621                        | 3,621                        | 3,621                        |
| <i>Adjusted-R<sup>2</sup></i>                                                                                                 | 0.26                         | 0.26                         | 0.26                         |

Note: Estimated by ordinary-least-squares with fixed- and time-effect models. The standard errors are cross-section (sector) cluster robust standard errors. First lag of sector-specific demand is included in estimation as control variables. Data extrapolation using the values in the closest periods is applied for the missing values in the estimates of shock heterogeneity.

\*\*\* Significant at the 1 percent level. \*\* Significant at the 5 percent level.\* Significant at the 10 percent level.