

Inflation Is a Supply Phenomenon

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Introduction

- ▶ Friedman's celebrated quote:

"Inflation is always and everywhere a monetary phenomenon, ...

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- ▶ Friedman's celebrated quote:

"Inflation is always and everywhere a monetary phenomenon, ... in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output."

- ▶ We analyze the meaning of the 2nd part of this quote
 - ▶ At face value, suggests that inflation only happens under **supply deficiencies**
 - ▶ A *sine qua non* condition
- ▶ In contrast, when supply is slack:
 - ▶ Little or no inflation is observed
(even for big shocks, even in the medium term)

Why and when is inflation a supply phenomenon?

When? When macroeconomic management is “fairly sound”

- ▶ Central bank independence (or monetary dominance)
- ▶ Anchored inflation expectations
Post-Volcker period (**post-Friedman era**)

Why? Because of **supply structure** and **nature of price setting**

- ▶ We discuss these two alternative views

When? In the short and medium run. The horizon matters:

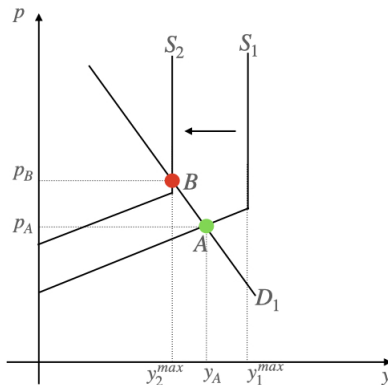
- ▶ Money is not neutral, even a decade after a monetary shock
(**BERNANKE & MIHOV (1986); JORDA, SINGH & TAYLOR (2024)**)
- ▶ But: Supply shocks produce sharp short-run inflation fluctuations

Our Approach

- ▶ Warning: This is a broad-brush piece
- ▶ On purpose:
 - ▶ No model (no math)
 - ▶ No serious identification efforts (casual data analysis)
- ▶ Trying to figure out what the agenda ought to be

Two Views

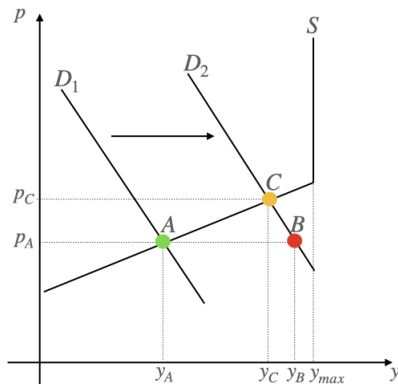
1. Kinked Supply Curves



Supply Shock With Supply Constraint

Two Views

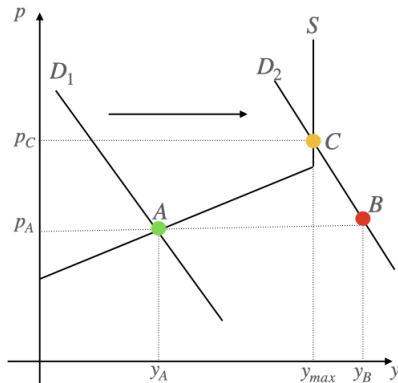
1. Kinked Supply Curves



Demand Shock Without Supply Constraint

Two Views

1. Kinked Supply Curves



Demand Shock With Supply Constraint

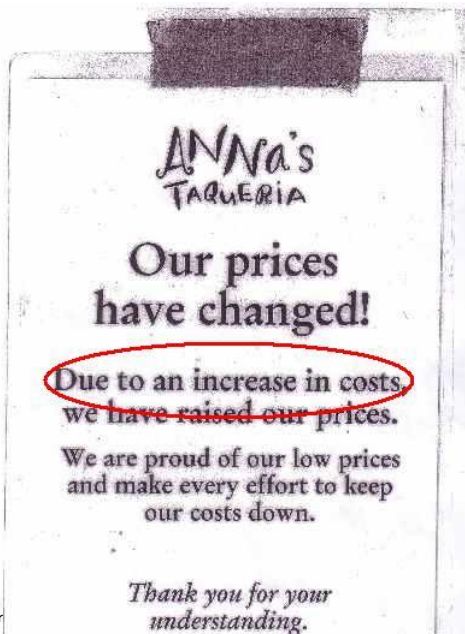
Two Views

2. Covering Costs as an Argument for Price Increases

- ▶ Old idea in macro:
 - ▶ Firms justify price increases as necessary to cover costs
- ▶ Okun (1983):

"It is easy for anyone to understand that cost increases can force the firm to break the continuity of its offer [...] Price increases that are based on cost increases are "fair", while those based on demand increases are viewed as unfair"
- ▶ This suggests: prices might be more flexible to supply shocks

Justifying Price Increases (Restaurant)



Two Views

2. Covering Costs as an Argument for Price Increases Recent Efforts to Take This Seriously, evidence

- ▶ Influential idea in behavioral economics: fairness
(KAHNEMAN, KNETSCH & THALER (1986); EYSTER & MICHAILLAT (2022))
- ▶ Rotemberg (2005, 2011): models of fairness
- ▶ Kohler, L'Huillier, Phelan & Weiss (2025): survey evidence from the Covid pandemic + strategic model

Implications

1. Easy to have flat PC that moves with supply
Not possible in standard NK model ([L'HUILLIER & PHELAN \(2025\)](#))
Able to match aggregate evidence: 1970s and post-covid
2. Identification: structure matters
3. Trade and geopolitics determine costs
... and inflation

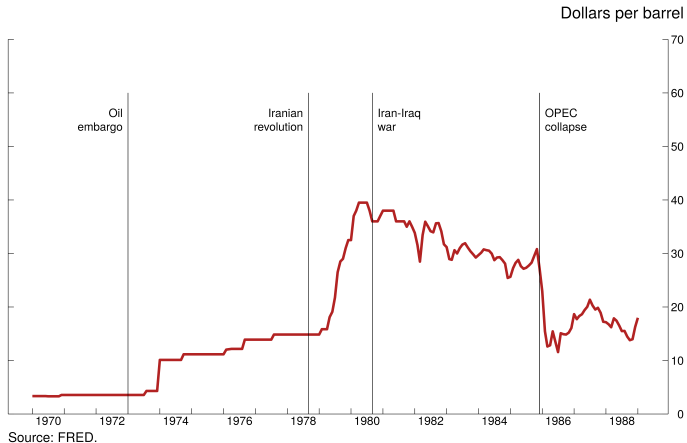
Implications:

4. The Volcker Disinflation: Commitment, or Good Luck?

- ▶ Standard narrative of 1980s disinflation: policy success
 - ▶ Volcker, high interest rates, and credibility
- ▶ But: stark contrast with 2024 disinflation
 - ▶ Inflation quickly moderated as supply normalized
- ▶ Q: Where there favorable supply factors in the 1980s? A: **YES**
 - ▶ These favorable supply factors have been overlooked

The Volcker Disinflation: Commitment, or Good Luck?

Spot Crude Oil Price and Role of Supply Normalization



Take Aways

- ▶ A richer supply-side modeling is warranted
 - ▶ Constraints (...), trade (...), geopolitics (...)
- ▶ A richer price-setting modeling is warranted
 - ▶ Shock dependence (...), fairness (...)
- ▶ Open questions and next steps:
 - ▶ Optimal policy?
 - ▶ Monetarism? Horizon? Thresholds at which it is relevant?
 - ▶ Next: Use earning calls to understand role of supply deficiencies in price increases