

# Cyclical Demand Shifts and Inflation Inequality

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First Version: February 2021

This Version: October 2024

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## **Abstract**

This paper studies how income-level inflation rates vary over the course of the business cycle and documents two new facts: (1) during recessions, prices rise more for products purchased relatively more by low-income households (necessities); and (2) the aggregate share of spending devoted to necessities is counter-cyclical. I present a mechanism where adverse macroeconomic shocks which lower expenditure cause households to shift expenditure away from luxuries toward necessities, which leads to higher relative prices for necessities. I show empirically, with monetary policy and oil news price shocks, that this mechanism operates for both demand and supply shocks. For the oil price shock, I decompose the effect on relative prices into a direct effect and an indirect effect due to the fall in real expenditure; the indirect effect is responsible for nearly half of the oil price induced change in relative necessity prices. I embed the mechanism into a quantitative model which is able to explain around half of the cyclical variation in necessity prices and shares and finds that changes in relative prices makes a recessionary shock similar to the Great Recession 22 percent more costly for households in the lowest income quintile than the highest. The results suggest that low-income households are hit twice by recessions: once by the recession itself and again as their price index increases relative to that of other households.

*JEL Classification: E30, D12*

*KEYWORDS: inflation, non-homotheticity, real income inequality, business cycle, monetary policy*

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I would like to thank Valerie Ramey, Johannes Wieland, Munseob Lee, Marc Muendler, Joey Engelberg, Jonathan Fisher, Brad Strum, Ekaterina Peneva, Robbie Minton, Daniel Villar, Erick Sager, David Argente, Colin Hottman, Juan Herreño, Fabian Trottner, Fabian Eckert, Steve Wu, and seminar participants at the Bank of England, Federal Reserve Board, Midwest Macro, EEA, SED, and UCSD for invaluable comments and advice. All views in this paper are my own and not the opinions of the Federal Reserve Board or Federal Reserve System.

# 1 Introduction

Since the 2008 financial crisis, a flurry of research has shown that recessionary shocks have heterogeneous effects on households and can exacerbate inequality.<sup>1</sup> Much of the past literature has focused on the cyclical behavior of nominal consumption and income inequality and has overlooked cost of living differences across households, which is the denominator of real inequality. This paper shows that failing to include differential changes in the cost-of-living can dramatically understate the true distributional consequences of recessions and other adverse shocks.

This study asserts that higher consumer price inflation for low-income households is a feature of recessions. I present a novel mechanism, “Cyclical Demand Shifts,” where contractionary shocks lead households to cut back on luxuries (e.g., vacations and pet services), but households continue to buy necessities (e.g., groceries). This shift in relative demand increases the relative price of necessities, which disproportionately affects poorer households since a larger share of their consumption basket is devoted to necessities. The mechanism implies that poor households are hit twice by recessions: once by the recession itself and again when the price of their basket increases relative to other households.

This paper makes three main contributions. First, I show empirically that while consumption falls during recessions, it does not fall equally for all products; specifically, consumption falls more for luxury products than necessities. Second, I show that the relative price of necessities is counter-cyclical. Third, I present a theoretical framework that incorporates the “Cyclical Demand Shifts” mechanism into a standard business cycle model. This model can explain a significant percentage of the cyclical behavior of relative necessity prices and consumption and estimates sizable increases in the relative cost-of-living for low-income households during recessions. Krueger et al. (2016) find that during the Great Recession, nominal consumption growth fell by 0.3 percent more for households in the lowest wealth quintile compared with those in the highest. A back-of-the-envelope calculation incorporating this paper’s cost-of-living inequality estimates suggests that the actual difference in the

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<sup>1</sup>See Heathcote et al. (2020), Feiveson et al. (2020), Krueger et al. (2016), Meyer and Sullivan (2013) and Hoynes et al. (2012)

fall of *real* consumption is almost four times as high at 1.15 percent.<sup>2</sup>

In order to study differences in household-level price indices across time, I match products in the BEA’s Personal Consumption Expenditures (PCE) with equivalent spending in the Consumer Expenditure Survey (CEX) resulting in 148 product sectors for which I have aggregate expenditure and prices, alongside household level purchasing patterns. I then sort CEX households into five different income quintiles. Next, I construct a measure of the relative importance of a product in a low-income household’s consumption basket by dividing the pooled average of the product’s nominal expenditure share for households in the first income quintile by the average expenditure share for that product of households in the highest income quintile (expenditure ratio).<sup>3</sup> I define necessities as products purchased more by low-income households (expenditure ratio greater than one) and luxuries as products purchased more by high-income households.

I define necessities based on household level consumption patterns, but how does *aggregate* consumption shifts between luxuries and necessities over the business cycle? I find that the aggregate expenditure share devoted to necessities has increased during every recession in my sample (from 1959 to 2024). I formally test the relationship between aggregate spending on necessities or luxuries and economic slack in a panel regression using all 148 product sectors. I find that a 1 percentage point increase in the unemployment rate is associated with a 1.9 percent increase in the aggregate share of spending on necessities. This relationship continues to hold even when controlling for whether products are durables or services.<sup>4</sup>

Figure 1 shows the inflation rates of necessities (solid in blue) and luxuries (dashed in red) from 1960 to 2024. On average the inflation rate of necessities has been 4.1 percent annually compared to 2.9 percent for luxuries. Higher inflation on average for products purchased relatively more by low-income households is consistent with the findings in prior literature (e.g. Jaravel and Lashkari (2024)). However, there is considerable variation in the difference between necessity and luxury inflation and during recessions the difference has averaged 2.2

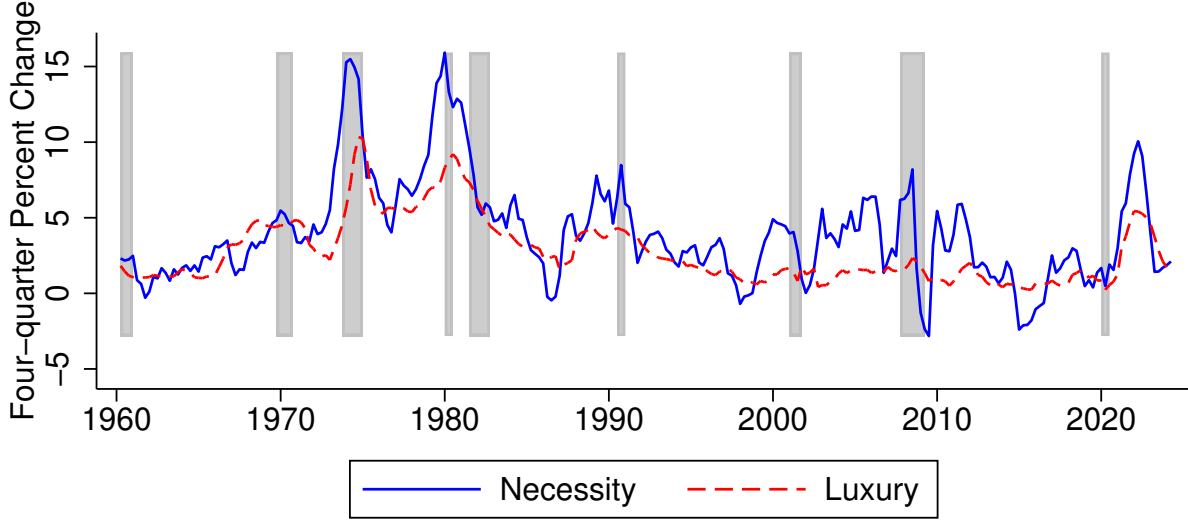
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<sup>2</sup>Krueger et al. (2016) classify households based on wealth levels, where this paper sorts households based on income.

<sup>3</sup>An expenditure ratio greater than one implies that the product’s Engel curve is downward sloping.

<sup>4</sup>This relationship is not simply mechanically related to higher necessity prices, as a necessity product’s relative real expenditure (nominal aggregate expenditure divided by the product-specific price index) is also positively related to unemployment.

**Figure 1:** Inflation Rates of Luxuries and Necessities



Source: BLS, BEA, and Author's own calculations.

Notes: Necessities defined as sectors whose average expenditure share from 1980-2023 was higher for low-income than high-income households. Chained fisher price indices. Excludes housing and non-market consumption.

percentage points, which is twice as large as during non-recessions.

After conditioning on oil prices, which have a larger cost-share in necessities, I find that the gap between necessity and luxury inflation rate increases during recessions, is positively associated with the unemployment rate, and is negatively associated with the output gap, and changes in real PCE. In a panel regression using the 148 product sectors, I find that a 1 percent increase in the unemployment rate is associated with a 0.1-0.4 percentage point increase in the gap between inflation for necessities and luxuries. This relationship is robust to including controls for whether the product is a durable, a service, and the typical price-change frequency of the product.

Having documented that both necessity relative prices and aggregate shares increase during recessions, I formally introduce a static model that can rationalize these facts. The critical components of this model are non-homothetic preferences at the aggregate level and a concave production possibilities frontier (PPF). The non-homothetic preferences lead to cyclical demand shifts between necessities and luxuries that track the evolution of aggregate consumption expenditure. The concave production possibilities frontier leads to higher

relative costs for the expanding sector. These components are sufficient for an aggregate decrease in expenditure to lead to a relative expansion in the necessity sector and higher relative necessity prices. The source of the shock to expenditure does not matter in the model, both aggregate demand shocks and supply shocks that induce the same fall in expenditure will induce the same change in relative prices when holding the relative supply curve constant. However, supply shocks that affect productivity in one sector more than the other can have an additional direct effect on the relative supply curve and can be decomposed into a direct effect on relative prices and a secondary income effect due to non-homothetic preferences and a concave PPF. For supply shocks that have a higher cost-share in necessity production, such as changes to the oil price, both the direct and secondary income effects will both lead to higher necessity prices.

Is aggregate demand non-homothetic? While the cross-sectional data show that low-income and high-income households buy different bundles, this finding does not necessarily imply that aggregate preferences are non-homothetic; i.e. in response to an exogenous shock that changes aggregate consumption, does the aggregate consumption bundle change?<sup>5</sup> I test this assumption along with the model’s primary conclusion, an increase in necessity prices following a decrease in aggregate expenditure, using monetary policy news shocks from Bauer and Swanson (2022b) as a stand in for a pure demand shock and oil price news shocks from Känzig (2021) as an adverse supply shock. These results show that an exogenous shock that lowers aggregate expenditure also leads to higher relative necessity prices and consumption.

Since the cyclical demand shift mechanism operates through changes in expenditure, I first show that both a one-standard deviation monetary policy news shock and a one-standard deviation oil price shock both lead to approximately 0.2 percent declines in real PCE spending that persist for several years after the initial shock. In a panel local projection of the 148 PCE sectors, the same one-standard deviation monetary policy shock leads to a 0.5 percent increase in the aggregate share of low-income intensive products and a 0.25 percent increase in their relative price, which implies that the necessity relative price elasticity to

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<sup>5</sup>This question is also related to the relationship between income and expenditure elasticities. I define products as necessities/luxuries based on income elasticity and then test the aggregate expenditure elasticity of these products. The relationship between household income and aggregate expenditure elasticities is partially responsible for cyclical price index disparities across income groups.

expenditure is around  $-1$ . These results are robust to other types of monetary policy shocks and to conditioning on the product's oil share in production, whether the product is a durable, and the product's price change frequency.

In panel local projections, I empirically decompose the oil price shock into a total effect on necessity relative shares and prices, and an indirect effect due to the oil-shock induced decline in expenditure. I find that the total effect of the oil price shock leads to approximately a 0.3 percent increase in necessity shares and a 0.2 percent increase in necessity prices in the three years following the shock. Part of the increase in relative prices is due to the much larger share that oil plays in necessity production (necessities include products such as gasoline). I isolate the indirect nonhomothetic effect of these oil price shocks on necessity relative shares and prices by conditioning the local projection at each horizon by the change in oil prices until that horizon interacted with the PCE sector's oil share in production. I find that the indirect effect on relative shares is approximately the same as the total effect. For relative necessity prices, I find that nearly half of the total effect of the oil price change is due to the indirect effect. In addition to testing the mechanism, these results show how important the non-homothetic indirect effect is for understanding the distributional consequences of oil price shocks.

Next, I present a quantitative New Keynesian model that incorporates non-homothetic preferences and can be calibrated to the U.S. economy. Household preferences are represented by the Almost Ideal Demand System (AIDS) (Deaton and Muellbauer 1980). While these preferences have been used in the trade literature, to my knowledge this is the first paper to incorporate these preferences into a New Keynesian style model. The AIDS inherits well-behaved aggregation properties from the Generalized Linear class of demand systems (Muellbauer 1975), which allows me to solve for aggregate necessity shares and relative necessity prices using a representative agent framework. I calibrate the model to match the United States' aggregate expenditure and necessity share in 2005-06, right before the Great Recession.

The quantitative model can explain a significant fraction of the cyclical variation in relative necessity prices and shares. In a validation exercise, I introduce a series of shocks to the model so that expenditure in the model exactly matches the cyclical component of

the PCE from 1994 to 2021, which results in model-produced time-series of necessity prices and shares. The model-produced time-series are highly correlated and of the same scale as their data counterparts: the model’s necessity price series has a 44 percent correlation with cyclical necessity prices in the data, and the necessity share series has a 55 percent correlation. Cyclical relative necessity prices peak in the Great Recession at around 5 percent in the model and 6 percent in the data.

With the model in hand, I examine the welfare consequences of the Great Recession when households have different price indices.<sup>6</sup> Using the non-homothetic price index implied by the AIDS, I estimate that the price index for low-income households increased by 0.85 percentage points relative to the price index of high-income households during the Great Recession (2007Q3-2009Q2). This large relative increase in cost-of-living can have considerable welfare consequences. I perform a test of the expenditure equivalent welfare loss due to the Great Recession, and I find that the Great Recession was 22 percent more costly for households in the bottom income quintile compared with households in the top quintile.

Taken together, the results suggest that the difference in cost-of-living between low- and high-income households varies systematically over the business cycle: increasing during recessions and subsiding during expansions. This cost of living channel is yet another reason why recessions are particularly costly for low-income households.

This paper is most closely related to a small but fast-growing literature examining changes in the cost of living across household groups. Early research by Amble and Stewart (1994), Garner et al. (1996), Hobijn and Lagakos (2005), and McGranahan and Paulson (2005) found only limited differences in inflation rates across demographic groups.<sup>7</sup> However, more recent work has leveraged detailed product categories as well as barcode level data to document substantial differences in inflation-rates across households (Kaplan and Schulhofer-Wohl 2017, Jaravel 2019, Cavallo 2020, Gürer and Weichenrieder 2020, Argente and Lee 2021, Lauper and Mangiante 2021). This literature has focused on either trends in inflation rate disparities (Jaravel 2019, Gürer and Weichenrieder 2020) or particular events such as the Great Reces-

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<sup>6</sup>Since the model abstracts from differences in employment loss or ability to borrow during the recession, these results are due only to differences in relative prices

<sup>7</sup>An exception in this early-period is work by Crawford and Oldfield (2002) who found that few households in Britain have inflation close to the official Retail Price Index

sion (Argente and Lee 2021), the 1994 Mexican devaluation (Cravino and Levchenko 2017), and the COVID-19 pandemic (Cavallo 2020, Jaravel and O’Connell 2020). In contrast, this paper shows empirically and theoretically that inflation inequality increases following any shock that affects aggregate consumption expenditure.<sup>8</sup>

This paper also contributes to the literature on endogenous demand shifts. For example, Jaimovich et al. (2019) show that households switched from high- to low-quality products during the Great Recession and this shift in demand led to lower labor demand since low-quality products use less labor in production. Over a longer horizon, Boppart (2014) and Comin et al. (2021), show that non-homothetic demand can explain the shift from agriculture to manufacturing and services in advanced economies. Comin et al. (2020) show how long-term shifts can contribute to labor-market polarization. Work by Bils and Klenow (1998) uses product expenditure elasticities to test competing business cycle models. This paper shows that over the short term, shifts in demand can lead to higher prices in the expanding sector, which can have heterogeneous effects on income-level cost of living. Contemporary work by Andreolli et al. (2024) finds a similar relationship between the relative expenditures on luxuries in necessities over the business cycle and in response to monetary policy shocks, but does not show that these results are robust to other major features of the product, such as its oil share or durability.

The remainder of the paper proceeds as follows: Section 2 describes how I define necessities and luxuries and presents the twin motivating facts (counter-cyclical necessity prices and aggregate shares), Section 3 formally presents the cyclical demand shift mechanism, Section 4 tests the conclusions of the mechanism empirically via monetary policy and oil price news shocks, Section 5 presents the quantitative model, and Section 6 concludes.

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<sup>8</sup>Inflation inequality may be a confusing term since price inflation traditionally has been defined as a general increase in the prices of goods and services in an economy or a decrease in the purchasing power of a particular currency. In the emerging literature on changes in the cost-of-living across income groups, “inflation inequality” is generally defined as differences in the change of the cost of achieving a particular level of utility across household groups (Jaravel 2021).



## 2 Data and Stylized Facts

In order to study the cyclical behavior of low-income versus high-income household inflation rates I focus on the products which are purchased relatively more by low-income households compared to high-income households. I call these low-income intensive products necessities and other products luxuries. This differs from the textbook definition of a necessity, which are products whose expenditure elasticity is less than one. At the cross-sectional level, the expenditure and income elasticity of a product are highly related since household income is highly correlated with household expenditure (in fact many studies use household income as an instrument for household expenditure when calculating Engel curves Aguiar and Bils (2015), Bils and Klenow (1998)).

I show that necessities, which I define in the household cross-section, exhibit counter-cyclical relative demand, which implies that they are also necessities in the aggregate time-series. I also show that conditional on the oil price, necessity relative inflation is counter-cyclical; relative necessity prices increase in tandem with relative necessity expenditure during recessions.

### 2.1 Defining Necessities and Luxuries

This project’s primary data sources are the Consumer Expenditure Survey (CEX) from the BLS, which I use to distinguish between luxury and necessity goods, and the Personal Consumption Expenditure price and expenditure (PCE) series from the underlying detail of the BEA’s National Income and Product Accounts. I combine these data sources with the BEA’s Total Requirement tables from the Input and Output accounts to construct sector-level oil production shares, and sector price change frequency data from Montag and Villar (2022).<sup>9</sup>

I divide households into five different income groups based on the household’s distribution in absolute income over the entire CEX sample (1980-2022) and derive the income-group

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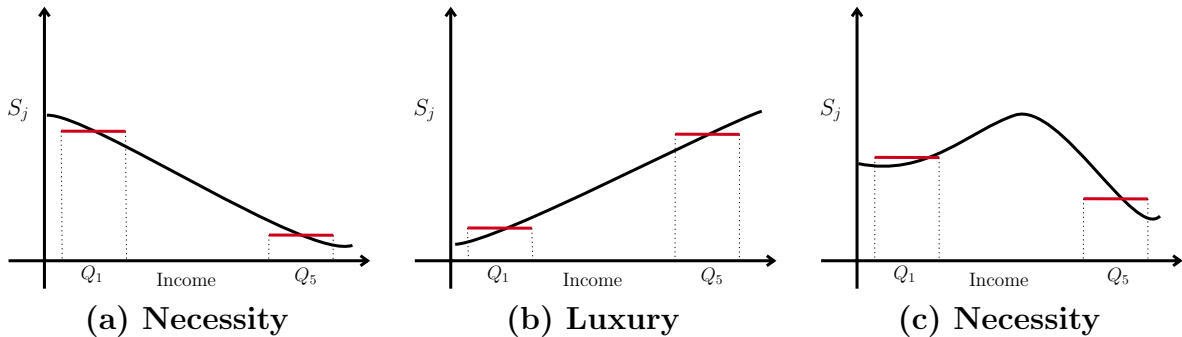
<sup>9</sup>The price change frequency data from Montag and Villar (2022) is at the entry level item (ELI) level. I match these to PCE categories by first matching ELI’s with CEX UCC codes using the BLS concordance, and then matching UCC codes to PCE sectors using the extended BLS CEX-PCE concordance that I discuss in section B of the online appendix.

expenditure shares on each of 148 different PCE categories that represent the same type of spending in the NIPA product accounts and the CEX (see the online appendix section B for details).<sup>10</sup> These 148 sectors represent 73 percent of all PCE spending in 2019. I pool the expenditure shares across time to create a single expenditure share for each income group and product. I define  $R_j$ , as the ratio of the share of consumer spending in the lowest income quintile to the share of spending in the highest quintile:

$$R_j = \frac{\sum_t \frac{1}{N_{t,Q1}} \sum_{h \in Q1} s_{jth}}{\sum_t \frac{1}{N_{t,Q5}} \sum_{h \in Q5} s_{jth}}. \quad (2.1)$$

$R_j$  is equal to one if, on average, low- and high-income households spend the same percentage of their expenditure on product  $j$ . I define products as necessity goods if low-income households have a higher expenditure share on these goods relative to high-income households ( $R_j > 1$ ), and I define luxury goods as products with  $R_j < 1$ .

**Figure 2:** Expenditure Ratio Based on Engel Curve



Note: Panel (a) shows a product  $j$  with a downward sloping Engel curve (necessity). Panel (b) shows a luxury product. Panel (c) shows a product with a hump shaped Engel curve; in this example, it is a necessity since the average expenditure share for  $j$  is higher for the lowest income group,  $Q_1$ , than the highest,  $Q_5$ .

Figure 2 shows how this approach is similar to comparing the level of the share based Engel curve at the top and bottom of the income distribution. If the Engel curve is linear, then the “necessity” rank of the good using this method would be the same as the rank derived from the slope of the Engel curve (where a slope of zero would correspond to an expenditure share ratio of one). If the underlying Engel curve is non-linear (as suggested by

<sup>10</sup>[TODO] In the online appendix I also show that my main results are also robust to classifying households into income groups based on their distribution in relative income for each individual monthly CEX survey rather than over the same sample.

Atkin, Faber, Fally, and Gonzalez-Navarro (2020)), then this method continues to rank goods by their importance in the consumption basket of low-income versus high-income households regardless of consumption patterns for the middle income-groups.

**Table 1:** Top luxury and necessity products

<b>Panel A: Top Luxury Sectors</b>			
<b>PCE Category</b>	<b>Percent Expenditure</b>		$R_j$
	<b>Low-Income</b>	<b>High-Income</b>	
Water transportation	0.01	0.03	0.26
Domestic services	0.10	0.35	0.28
Wine	0.02	0.06	0.34
Spirits	0.01	0.03	0.33
Passenger fares for foreign travel	0.16	0.45	0.36
Hotels and motels	0.32	0.85	0.37
Musical instruments	0.03	0.09	0.35
Jewelry	0.12	0.34	0.37
Clocks, lamps, lighting fixtures, and other household decorative items	0.10	0.26	0.36
Amusement parks, campgrounds, and related recreational services	0.09	0.23	0.38
<b>Panel B: Top Necessity Sectors</b>			
<b>PCE Category</b>	<b>Percent Expenditure</b>		$R_j$
	<b>Low-Income</b>	<b>High-Income</b>	
Tobacco	1.07	0.40	2.66
Other fuels	0.05	0.02	2.05
Pork	0.57	0.29	2.00
Eggs	0.19	0.09	1.99
Lubricants and fluids	0.06	0.03	1.80
Beef and veal	0.82	0.45	1.83
Fresh milk	0.76	0.43	1.76
Poultry	0.55	0.32	1.73
Other meats	0.39	0.23	1.70
Electricity	3.36	2.03	1.66

Note: Expenditure ratio ( $R_j$ ) is defined as the average expenditure share of households in the bottom income group divided by the average expenditure share of households in the top income group.

Source: Consumer expenditure survey and author's own calculations.

Table 1 Panel A shows the top 10 luxury goods. The consumption category that has the highest comparative expenditure by those in the top income group is “Water transportation”, which has an expenditure ratio,  $R_j$ , of 0.26. So, on average, households in the highest income

group spend 3.8 times as much of their budget on this category compared to households in the lowest income group. Other top luxury goods include Domestic Services, Wine, and Hotels and motels. Panel B shows the top 10 necessity goods. These include tobacco products, energy, and food products.

Table 2 shows that luxuries tend to be more concentrated in services and durable goods, have higher oil requirements in production and adjust prices more frequently. The average oil production share for each good is derived from the BEA’s Total Requirement tables for commodities combined with their PCE bridge file.<sup>11</sup> As shown in figure 3 panel A, most product sectors have a rather low oil share in production (the median is 2.4 percent), but there are some large outliers. For example, it perhaps goes without saying that gasoline is the PCE sector with the highest share of oil in total production costs (nearly 80 percent). Some of the other PCE sectors with high oil shares include other energy sectors, which are mostly necessities and public transportation sectors such as air travel, which tend to be luxuries. I take the price change frequency from each sector from Montag and Villar (2022).<sup>12</sup> Like the oil share, the price change frequency is highly concentrated at a low level and the median product has a price change frequency of only 8 percent. However, there are also some large outliers amongst both necessities and luxuries. These outliers also tend to be transportation services and energy products, although motor vehicles and parts subcategories also tend to adjust prices more frequently.<sup>13</sup>

## 2.2 Necessity Relative Expenditure Shares and Prices are Counter-Cyclical

### **Fact 1: Relative Spending on Necessities is Counter-Cyclical**

In US recessions since 1959 total PCE has tended to decline. The annualized quarterly total PCE growth rate in NBER recessions has average  $-0.1$  percent, while during non-recessions it has average  $0.4$  percent. Figure 4 shows that the fall in expenditure during

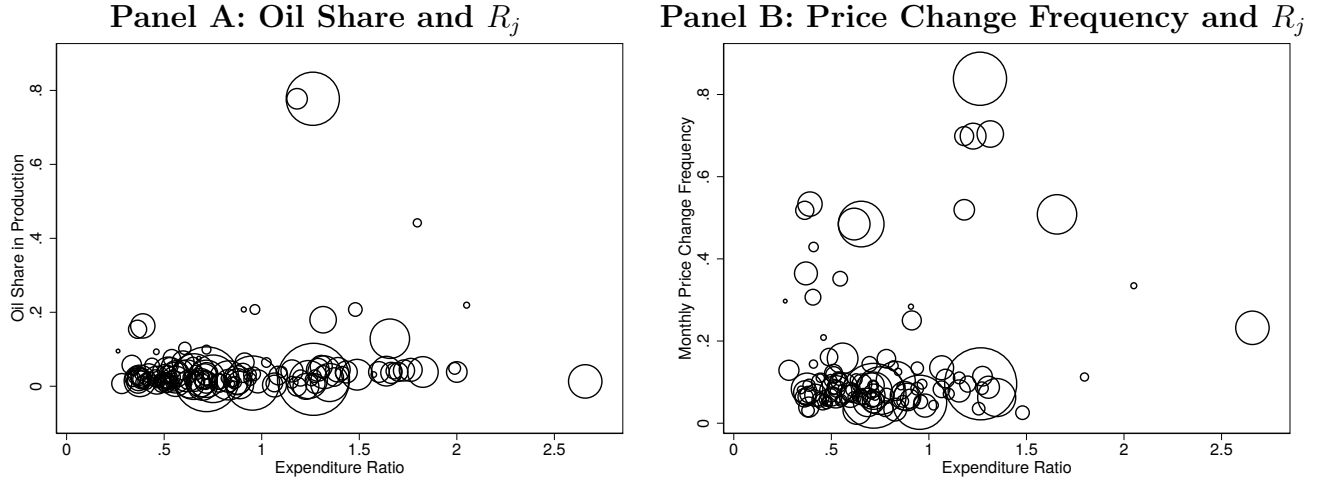
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<sup>11</sup>I use the 2012 Total Requirements table, but my results are robust to using the 2007 or 2017 tables.

<sup>12</sup>Only 117 of the 148 PCE sectors have matching price frequency data from Montag and Villar (2022) since the price micro-data for some PCE sectors is not available.

<sup>13</sup>All median and average statistics in this paragraph are weighted by the PCE sector’s share in aggregate expenditure.

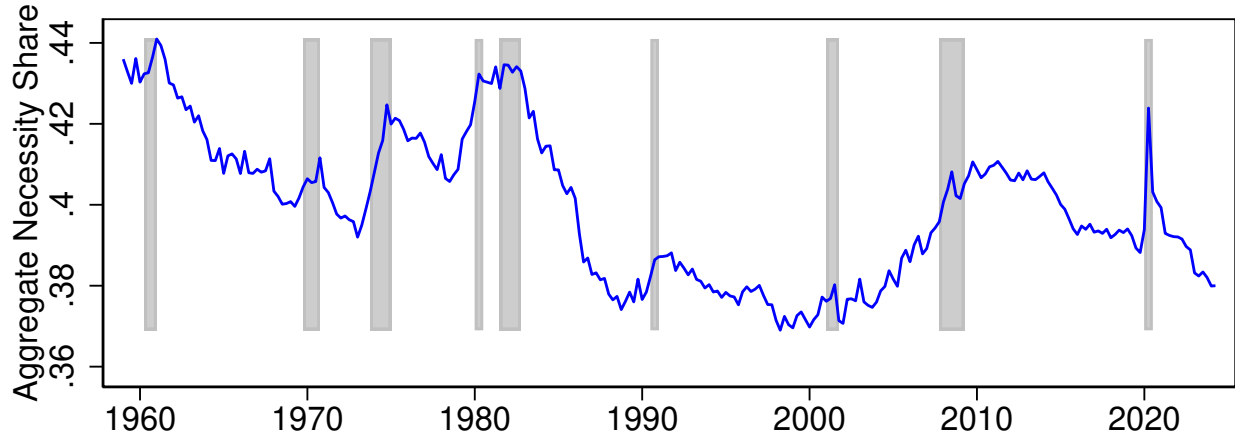
**Figure 3:** Oil Share, Price Frequency, and  $R_j$



Source: Consumer Expenditure Survey, BEA, Montag and Villar (2022) and author's own calculations.

Note: The size of the circles denotes that PCE sector's average share in aggregate expenditure.

**Figure 4:** Aggregate Expenditure Share on Necessities



Source: Consumer Expenditure Survey, BEA, and author's own calculations.

Note: The necessity share of aggregate expenditure is the total share of aggregate expenditure using the 148 included PCE categories and excludes non-market and housing products.

**Table 2:** Descriptive statistics for luxuries and necessities

Descriptive Stats		
	<b>Necessity</b>	<b>Luxury</b>
Average Oil Production Share	0.12	0.02
Monthly Fraction Price Change	0.32	0.13
Percent expenditure durables	7%	19%
Percent expenditure services	48%	67%

Source: Consumer expenditure survey, BEA, Montag and Villar (2022), and author’s own calculations.

Note: These 148 products exclude the two housing products: rent and owners equivalent rent. The oil share is derived from the 2012 BEA total requirements commodity table combined with the commodity PCE bridge. Sectoral price frequency is the average from 1978-2023 excluding sales and is aggregated from the BLS entry level item (ELI) level using 1998 CEX weights. The percent of expenditure in durables or services is based on 2019 PCE data.

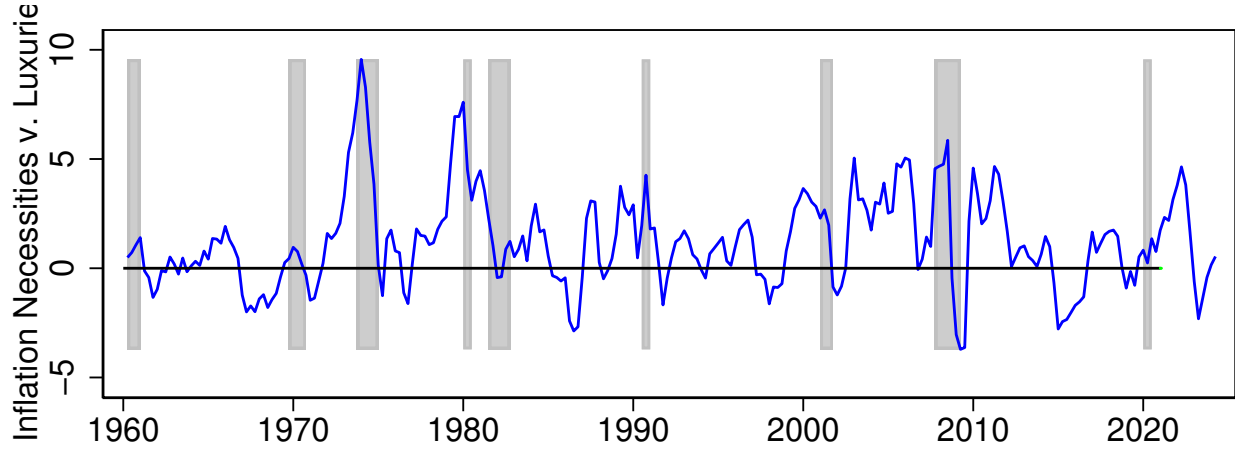
recessions is not equal for all products and that falls in luxury expenditure (leading to relatively higher necessity expenditure) are responsible for the majority of the fall in PCE during recessions. While the aggregate necessity share has fallen from about 43 percent at the start of the sample to 38 percent in 2024, there is considerable cyclical variation and the aggregate necessity share has increased in every single recession since 1959. This figure shows that while necessities in this paper are defined using income at the household level, these same products also tend to be necessities at the aggregate time-series level.

### **Fact 2: Counter-Cyclical Necessity Prices**

Figure 5 shows the difference between the necessity and luxury four-quarter inflation rates originally shown in figure 1. From 1960-2024, necessity inflation has averaged 1.2 percentage points higher than luxury inflation. During NBER recessions the gap is over twice as large at 2.2 percentage points compared to 1 percentage point during non-recessions. As I will show in table 3, part of this gap is due to oil prices since necessities have a larger oil-cost share in production than luxuries, however, even when conditioning on oil prices the gap between necessity and luxury inflation is 0.7 percentage points higher in recessions than non-recessions.

Table 3, which displays the results of simple time-series regressions of the inflation gap on aggregate variables, shows that after conditioning for oil prices the gap between necessity

**Figure 5:** Inflation difference between Necessities and Luxuries



Source: Consumer Expenditure Survey, BEA, and author's own calculations.

Note: Graph shows the difference in the 12-month fisher inflation rates between necessity and luxury sectors. Necessities defined as sectors whose average expenditure share from 1980-2023 was higher for low-income than high-income households ( $R_j > 1$ ). Chained fisher price indices. Excludes housing and non-market consumption.

**Table 3:** Time Series Data: Necessity Relative Inflation is Countercyclical

	Difference Necessity v. Luxury Inflation				
	(1)	(2)	(3)	(4)	(5)
Right hand side variables:					
NBER Recession	1.16 (0.72)	0.67** (0.29)			
Unemployment Rate			0.15* (0.090)		
Output Gap				-3.79 (9.22)	
$\Delta$ Real PCE					-1.24** (0.59)
$\Delta$ Oil Price		0.054*** (0.0043)	0.057*** (0.0042)	0.056*** (0.0043)	0.055*** (0.0035)
Observations	258	258	258	258	258

Notes: Newey-West HAC Standard errors in parentheses.  $*p < 0.1$ ,  $**p < 0.05$ ,  $***p < 0.01$ . The dependent variable is the difference between the Four-quarter Fisher Necessity Inflation rate and the 4-quarter Fisher Luxury Inflation rate.

and luxury inflation widens in periods of economic slack. Column 1, which regresses the inflation gap on a binary variable for the quarter being an NBER recession shows that the inflation gap is 1.2 percentage points higher in NBER recession quarters than other quarters. Column 2, adds the 4-quarter change in the WTI oil-price as a control and shows that the gap is still around 0.7 percentage points higher in NBER recessions; here the results are also more precise. In column 3, I use the unemployment rate instead of the NBER recession as the measure of economic slack and I find that a one percentage point increase in the unemployment rate is associated with a 0.15 percentage point increase in necessity inflation relative to luxury inflation. In column 4, I use the output gap and here I find a negative association between an output gap that is one percentage point higher, meaning that the economy is growing faster than potential, and the gap between necessity and luxury inflation (-3.8 percentage points). Finally, in the last column I show that a one percentage point stronger growth in real PCE spending is associated with a 1.2 percentage point smaller gap in necessity versus luxury inflation.

## 2.3 Panel Evidence

The aggregate evidence presented shows that on average necessity relative expenditure increases in recessions along with their relative prices, however, the aggregate evidence is not able to parse out whether this counter-cyclical behavior is due to products being necessities rather than other features of products that are correlated with both income elasticity and cyclicalities. For example, table 2 shows that necessities are less likely to be durables than luxuries, slightly less likely to be services, adjust prices much more frequently, and have a much larger oil share in production. Past literature has shown that durable purchases are quite cyclically sensitive (McKay and Wieland 2021, Barsky et al. 2007) and service expenditure tends to be much smoother than good expenditure.<sup>14</sup>

I am able to exploit the panel nature of the 148 product sectors that I study to at-least partially assuage concerns that other aspects of necessity products are solely responsible for

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<sup>14</sup>For some service categories, the BEA estimates service expenditure using a single annual survey and then extrapolates for the rest of the year U.S. Bureau of Economic Analysis (2023), which could mechanically make service consumption smoother than good consumption.



the counter-cyclical nature of necessity relative shares and prices. I do this using a simple regression:

$$x_{j,t} = \beta_0 + \beta_1 U_t \times 1\{R_j > 1\} + \beta_1 U_t \times Z_j + \beta_2 \Delta P_t^O \times S_j^O + \delta_t + \gamma_j + \varepsilon_{j,t}. \quad (2.2)$$

Here, the dependent variable,  $x_{j,t}$  is the log-share of products in sector  $j$  at time  $t$  or the sector level 12-month inflation rate. The dependent variable is regressed on the interaction of the unemployment rate with  $1\{R_j > 1\}$  a binary variable equal to one if the product is a necessity (I show qualitatively similar results in the appendix where I instead use the continuous  $R_j$ ). I also include time  $\delta_t$  and sector  $\gamma_j$  fixed effects (which absorb the level effect in the interaction).  $Z_j$  is a vector that include binary variables for whether the product is a durable, whether the product is a service, and a continuous variable for the average frequency of price change of that sector from Montag and Villar (2022).<sup>15</sup> Finally,  $\Delta P^O$  is the 12-month change in the WTI oil price and  $S_j^O$  is the sector level share of oil in total production costs from the BEA input-output tables. Controlling for the price of oil results in much more precise estimates since necessities have a much higher cost-share of oil in final production and the price of oil is much more volatile than the unemployment rate.

Table 4 shows the results from these regressions. In column one and four I show results from a simplified version of the panel regression where in addition to the interaction of interest (between the unemployment rate and necessity) I include an interaction between the change in the oil price and necessity. Here I find that a one percentage point increase in the unemployment rate is associated with a 1.85 percentage point increase in the share of aggregate expenditure spent on the product if it is a necessity (I multiply the coefficient by 100 to ease interpretation) and a 0.15 percentage point increase in the product's relative inflation rate. In columns two and five I instead control for the interaction between the change in the oil price and the product specific oil share in production, which yields very similar results. Finally in columns three and six I also include the  $U_t \times Z_j$  interactions which condition on whether the product is a durable, service, and the frequency of price change

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<sup>15</sup>The average frequency of price change is based on BLS micro-level CPI data and is constructed from 1978-2023 and excludes temporary sales.

of the sector.<sup>16</sup> In the final columns, results are quite similar for the relationship between the unemployment and the relative expenditure share of necessities; however, results are much larger for inflation, where a one percentage point increase in the unemployment rate is associated with a 0.4 percentage point increase in relative necessity inflation once conditioned on each product's price change frequency, and whether the product is a service or durable.

To summarize, I find a statistically and economically significant correlation between relative necessity inflation and expenditure shares with the unemployment rate. This result is not driven by differences in the oil-share of the sector, its price change frequency or whether the product is a durable or service. In the next section, I present a mechanism that can explain these two facts.

### 3 A Static Model of Relative Supply and Demand

In this section, I formalize the intuition behind the cyclical demand shift mechanism. I present a static model with a necessity and a luxury sector represented by perfectly competitive firms with concave production over labor. Households have non-homothetic preferences over those two sectors. This model is presented in partial equilibrium, and I abstract from the household labor market and savings decisions. Instead, the level of household expenditure,  $X$ , is exogenous. I show that a decline in the expenditure level,  $X$ , leads to higher equilibrium consumption shares and prices for the necessity sector. I also show, under the same assumptions, how a negative supply shock that both lowers expenditure and productivity for one sector can be decomposed into a direct effect on relative prices and an indirect effect on relative prices coming through the expenditure channel.

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<sup>16</sup>The sample size is smaller in columns 3 and 6 since as described in sub-section 2.1 there are some PCE categories for which I do not have data on price adjustment frequency.

**Table 4:** Relative Necessity Shares and Inflation increase with Unemployment

	100× Log-Share			Inflation		
	(1)	(2)	(3)	(4)	(5)	(6)
Right hand side variables:						
UR × Necessity	1.85*** (0.17)	1.85*** (0.17)	1.90*** (0.30)	0.15** (0.07)	0.12** (0.06)	0.42*** (0.08)
Δ Oil Price × Necessity	0.02* (0.01)			0.05*** (0.00)		
Δ Oil Price × Oil Share		0.30*** (0.10)	0.32*** (0.10)		0.57*** (0.04)	0.57*** (0.03)
UR × PC Frequency			2.69** (1.08)			-0.31 (0.36)
UR × Service			0.40 (1.50)			0.35*** (0.11)
UR × Durable			-2.70*** (0.71)			0.42*** (0.11)
Sector FE	Yes	Yes	Yes	Yes	Yes	Yes
Time FE	Yes	Yes	Yes	Yes	Yes	Yes
Weighted	Yes	Yes	Yes	Yes	Yes	Yes
Observations	113,040	112,254	88,560	111,276	110,502	87,180

Notes: The unit of observation is at the sector-time level. Necessity is defined as a sector with an expenditure share equal to or greater than one (low-income households consume relatively more than high-income households). Inflation is the 12-month percent change in the consumption sector price level. The change in oil price is the 12-month percent change in WTI prices. Standard errors, in parentheses, are clustered at the time level and are robust to auto-correlation. Significance at the 1, 5, and 10 percent levels indicated by \*\*\*, \*\*, and \*.

### 3.1 Firms

There are two sectors  $\{N, L\}$ . Each sector is competitive and is represented by a firm with a homogeneous production function over labor:

$$Y_i = F(H_i). \quad (3.1)$$

I assume that  $F(\cdot)$  is positive and homogeneous of degree  $k \in (0, 1)$ , implying that the firm has concave production over labor. Firms can hire labor at an exogenous fixed wage rate  $w$ . Profit maximization implies that the ratio of the wage and the sector price is equal to the

marginal productivity of labor:

$$\frac{w}{p_i} = F_H(H_i). \quad (3.2)$$

Lemma 1 (see mathematical appendix), shows that the marginal rate of transformation (MRT) between the two sectors is increasing (i.e. the production possibilities frontier (PPF) between the two sectors is concave). Since markets are competitive, this is akin to saying that:

$$\frac{p_i}{p_j} = \frac{F_{j,H}(H_j)}{F_{i,H}(H_i)} = \frac{F_{j,H}(F_j^{-1}(Y_j))}{F_{i,H}(F_i^{-1}(Y_i))} \quad (3.3)$$

is sloping upward in  $\left(\frac{Y_i}{Y_j}, \frac{p_i}{p_j}\right)$  space over some range  $Y$ . Intuitively, in the short-term firms, can expand only by changing their labor input. If one sector expands relative to the other, they must expand by increasing their relative share of labor, which increases their relative marginal cost. An example of this type of production function pair would be  $F_i(H_i) = A_i H_i^\alpha$  where  $\alpha \in (0, 1)$  and is common across sectors.<sup>17</sup> If both sectors have linear production over labor, then the relative marginal cost curve would be flat. An increasing marginal product of labor would lead to a downward-sloping curve.

### 3.2 Households and Intratemporal Substitution

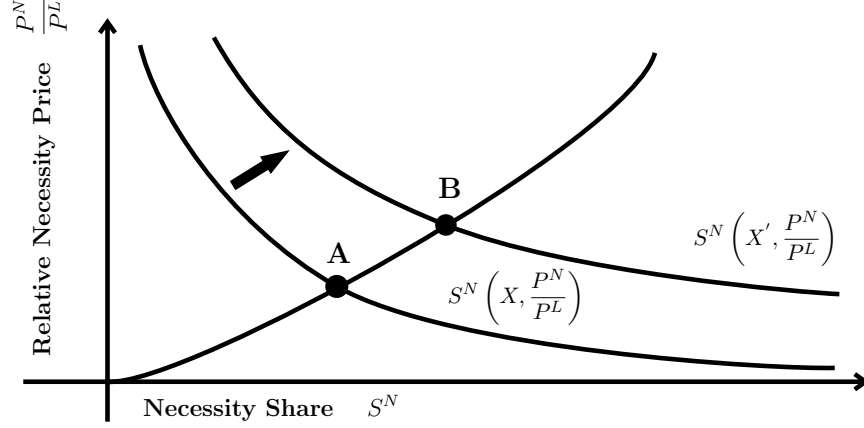
The representative household is given an exogenous endowment of expenditure,  $X$ . They have non-homothetic preferences over consumption in the necessity and luxury sectors  $U(c_N, c_L)$  such that for prices  $p_N, p_L$  and nominal expenditure  $X$  over some interval around  $X$ , the ordinary demand of the luxury good  $C^L(\cdot)$  increases in relation to that of the necessity good with an increase in  $X$ :

$$\frac{\partial}{\partial X} \frac{C^L(X, p_N, p_L)}{C^N(X, p_N, p_L)} > 0. \quad (3.4)$$

---

<sup>17</sup>If sectors each have production over labor, but not of the same curvature (i.e. it violates the assumption of production being homogeneous of degree  $k \in (0, 1)$  for each sector) then the relative supply curve is not necessarily upward sloping across the domain. For example, suppose that both sectors decrease production, but one sector  $j$  decreases production more. Sector  $j$  will shrink relative to the other sector, but the actual change in relative marginal costs will depend on the size of the decrease in average production versus the relative decrease in production in sector  $j$ .

**Figure 6:** Relative Demand to Expenditure Shock



Note: The relative demand curve, which slopes downward, shows how demand for necessities varies with the relative necessity price for a fixed level of expenditure. The relative supply curve shows the quantity provided of necessities relative to luxuries at different relative necessity prices and in this example it slopes upward. The economy starts at point A. After a shock that *lowers* expenditure from  $X$  to  $X'$  the relative curve shifts outward and the economy moves to point B.

Since we have only two goods, this equation implies that when  $X$  increases, the share spent on the necessity good  $s_N$  decreases.

Figure 6 shows a representation of how the relative marginal cost curves (relative supply) and relative demand could look in  $(s_N, \frac{P^N}{P^L})$  space. The relative supply curve slopes upward because of the homogeneous production of degree  $k \in (0, 1)$  in each sector. The relative demand curve slopes downward, as with only two goods they must be net substitutes. If there is a decrease in expenditure  $X$ , then relative demand for necessities will rise, and the relative demand curve will shift to the right. Equilibrium necessity expenditure share and the relative price will both increase (as pictured, this is a move from point A to point B).

The intuition behind figure 6 is stated formally in the following proposition (the proof is included in the mathematical appendix).<sup>18</sup>

**Proposition 1** *In a two-sector competitive economy with a representative household that has preferences satisfying equation (3.4), production function in each sector  $F_i(H_i) : [0, \infty) \rightarrow [0, \infty)$  both homogeneous of degree  $k \in (0, 1)$  and standard market clearing conditions, then*

<sup>18</sup>In the proposition, the representative household is assumed to have non-homothetic consumption preferences. However, this is not always the same assumption as the micro-level households having non-homothetic consumption preferences. I discuss this issue in more detail in the mathematical appendix.

*an decrease/increase in household expenditure will lead to an increase/decrease in the relative price of necessities.*

### 3.3 Relative Supply Shocks

Proposition 1 shows that when there are non-homothetic preferences and a concave production possibility frontier then changes in expenditure lead to changes in relative prices for necessities. This proposition does not address the source of the shock to expenditure whether it be a shock to aggregate demand or supply, but in principle both aggregate demand and supply shocks that change expenditure will lead to the same proportional affect on relative prices given that they do not shift the relative supply curve. However, a supply shock that affects the productivity of one sector more than the other would have an ambiguous affect on relative prices or shares.

As an example, suppose that there is a shock to labor productivity in both sectors,  $A_{t,j}$  so that  $F_{j,H}(A_{t,j}H_j) < F_{j,H}(H_j) \forall H_j$ , furthermore suppose that the fall in labor productivity is relatively greater in the necessity sector, so that:

$$\frac{F_{L,H}(A_{L,t}H_L)}{F_{N,H}(A_{N,t}H_N)} > \frac{F_{L,H}(H_L)}{F_{N,H}(H_N)} \forall (H_N, H_L). \quad (3.5)$$

It follows that for every level of the necessity share  $S^N$ , the relative price of necessities will be greater since it has become relatively less productive to produce them. This example is depicted in figure 7 where the economy moves from point A to point B. Since the economy is now less productive in aggregate, expenditure falls, which triggers the mechanism from proposition 1 and the relative demand curve shifts outward. This causes the economy to move to point C. In this example, both the effect on relative prices coming from the shift of the relative supply curve 3.5 and the indirect effect from the shift in the relative demand curve both lead to higher relative necessity prices leaving them unambiguously higher. The change in the necessity share is ambiguous however, as the rise in relative necessity prices coming from 3.5 and the fall in expenditure decrease and increase respectively  $S^N$  and the overall effect on the necessity share will depend on the price elasticity of demand for necessities,

the change in expenditure, and the expenditure elasticity of necessities. If instead the fall in labor productivity is greater in the luxury sector then the necessity share will increase, while the change in relative prices will be ambiguous.

We can decompose the change in relative prices into a direct effect with the new labor productivity (holding expenditure constant) and an indirect effect coming from both the induced change in the relative demand for necessities at the old expenditure level (a move along the relative demand curve) and the change in relative demand for necessities due to the change in expenditure (a shift of the relative demand curve):

$$\Delta \log \left( \frac{p_{N,t}}{p_{L,t}} \right) = \underbrace{(k-1) \log \left( \frac{A_{L,t}}{A_{N,t}} \right)}_{\text{Direct Effect}} + \underbrace{\Delta \log \left( \frac{F_{L,H}(H_{L,t})}{F_{N,H}(H_{N,t})} \right)}_{\text{Indirect Effect}}. \quad (3.6)$$

The direct effect of the change in labor productivity on relative prices is log-linearly proportional to the relative productivity change in each sector.<sup>19</sup> Equation 3.6 is not reliant on the assumption of an upward sloping relative supply curve, and can also be derived in the same way if both production functions are homogeneous of degree  $k \in (-\infty, \infty)$ .

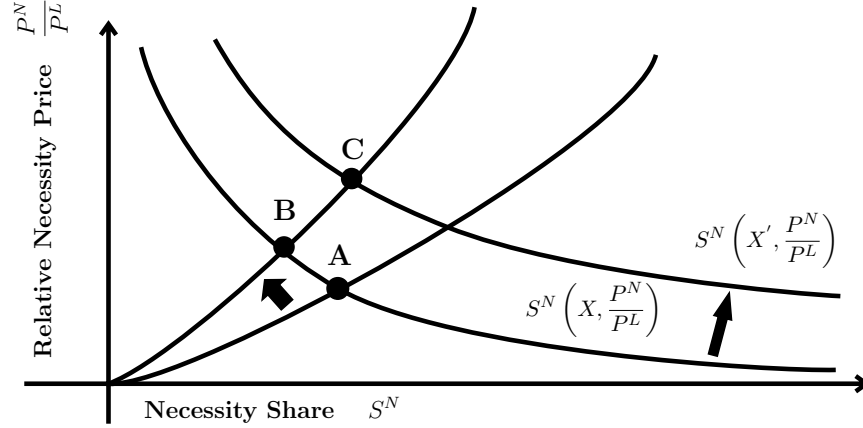
The indirect effect can be further decomposed into the move along the relative demand curve  $MD$ , which is dependent on the price elasticity of demand and the shift of the relative demand curve  $SD$ , which is dependent on the elasticity of expenditure to the supply shock and the expenditure elasticity of necessities.

$$\underbrace{\Delta \log \left( \frac{F_{L,H}(H_{L,t})}{F_{N,H}(H_{N,t})} \right)}_{\text{Indirect Effect}} = MD + SD. \quad (3.7)$$

---

<sup>19</sup>If we relax the assumption that both productivity functions are homogeneous of degree  $k$  and instead assume that both the necessity and luxury production functions are homogeneous, but of degrees  $k$  and  $g$  respectively then the direct affect would not only be proportional to the relative changes in productivity, but also depend on the degrees of homogeneity of the two functions  $(k-1) \log \left( \frac{1}{A_{N,t}} \right) - (g-1) \log \left( \frac{1}{A_{L,t}} \right)$ .

**Figure 7:** Relative supply and Relative Demand to Supply Shock



Note: The economy starts at point A. A negative supply shock affects production of necessities relatively more, which causes the relative supply curve to move up and inward, which would shift the economy to point B absent any change to total expenditure. The negative supply curve also lowers expenditure from  $X$  to  $X'$ , which shifts the relative demand curve outward and the economy ends at point C.

## 4 Empirical Strategy

The static model in the previous section showed how under certain assumptions lower aggregate expenditure leads to a higher relative share of necessities in aggregate expenditure, as well as an increase in the relative price of necessities. I use exogenous shocks to expenditure to test: (1) how the aggregate necessity share responds to a shock that lowers expenditure, and (2) how relative necessity prices respond to the same shock. These two questions are directly related to the assumption that the representative consumer has non-homothetic preferences and the assumption that the relative supply curve is upward sloping.

To test the model assumptions, I use plausibly exogenous monetary and oil price shocks. Both of these shocks lead to statistically significant declines in real PCE. The monetary shock is the quintessential example of an aggregate demand shock and assumed to shift *only* the relative demand curve and leave the relative supply curve unchanged. This is important as any shock that directly affects the position of the relative supply curve will obscure efforts to test its slope. In contrast, for oil price shocks, I discuss under what assumptions I can control for shifts in the relative supply curve and decompose the oil price shock into a direct effect and an indirect non-homothetic effect on relative prices similar to equation (3.6).



I find that a one-standard deviation contractionary monetary policy shock or oil shock each lead to around a [0.2] percent decline in aggregate real consumption spending 24- to 36- months after the shock. This same monetary shock leads to an increase of around [0.5] percentage points in the share of expenditure on necessities and an increase in necessity prices of approximately [0.2] percent, which implies an elasticity of relative necessity prices to aggregate expenditure of around  $-1$ . The oil price shock leads to an approximately [0.2] percentage point increase in the necessity expenditure share and after controlling for the sector’s oil share, an indirect effect on relative necessity prices of approximately 0.1 percent.

## 4.1 Aggregate Demand Shock: Monetary Contraction

In the textbook New Keynesian model, the interest rate appears only in the household side of the model and operates through the Euler Equation (Galí 2015), which makes monetary policy shocks a natural candidate for testing how necessity relative shares and prices respond to a shock that affects expenditure, but not the relative supply curve. I will address potential violations of this assumption later in subsection 4.1.2.

Since central banks respond to macroeconomic events, making interest rate changes endogenous, there is a large literature using monetary policy news as an external shock on interest rates (Gürkaynak et al. 2004, Gertler and Karadi 2015, Miranda-Agrippino and Ricco 2021, Bauer and Swanson 2022a). As a proxy for a monetary policy shock, I use the estimated monetary policy news shock from Bauer and Swanson (2022b).<sup>20</sup> This news shock is computed as the first principle component of the change in the first four quarterly Euro-Dollar contracts in a 30-minute window around each Federal Open Market Committee (FOMC) meeting and Fed Chair speech from 1988 to 2019. The first principle component is then orthogonalized with respect to macroeconomic news known to traders before the FOMC announcement. In the appendix, I show that qualitatively similar results on relative necessity prices are obtained when I instead use the news shocks from Gertler and Karadi (2015) or the news shocks orthogonalized to the Federal Reserve staff forecast developed by Miranda-Agrippino and Ricco (2021).

In order to test the differential response of interest changes on necessity and luxury

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<sup>20</sup>See also Swanson and Jayawickrema (2022).

product shares and prices, I estimate a local projection of the dependent variable ( $x_j$ ) on the interaction between the monetary policy shock and the product's expenditure ratio (Jordà 2005):

$$x_{j,t+h} = \sum_{k=0}^{12} [\gamma^{h,k} i_{t-k} \times R_j + \Gamma_{h,k} W_{j,t-k}] + \sum_{l=1}^{12} \left[ \sum_{y \in \{s,p\}} (\beta^{y,l} y_{j,t-l}) \right] + \delta_t + \psi_j + \alpha_{j,t+h}. \quad (4.1)$$

In the above equation, the dependent variable,  $x_{j,t+h}$ , is either the log-aggregate share of product  $j$  at time  $t+h$  or the log-price. The coefficient of interest  $\gamma^{h,0}$  (the coefficient of the interaction of the contemporary monetary policy shock  $i_t$  and expenditure ratio  $R_j$ ) is the differential response of sector shares/prices based on expenditure ratio, which corresponds to the Blinder-Oaxaca extension to the local projection framework discussed in Cloyne et al. (2020). In each regression, I include a year of lags of both dependent variable,  $\sum_{l=1}^{12} \sum_{y \in \{s,p\}} (\beta^{y,l} y_{j,t-l})$ . I include time fixed effects,  $\delta_t$ , which absorb the direct effect of monetary policy on shares/prices, as well as any other macroeconomic events occurring at time  $t$ . I also include product fixed effects,  $\psi_j$ , which control for the average level of share/prices for product  $j$ . I include a year of lags of all monetary policy shock interactions to account for serial correlation of the monetary policy shocks (Ramey 2016). All regressions use standard errors that are clustered at the time level and are robust to serial correlation.<sup>21</sup>

The main identifying assumption is that monetary shocks affect product prices differently only to the extent that they shift demand through non-homothetic preferences. However, demand for durable goods can be more sensitive to interest rate changes than for non-durable goods and services (McKay and Wieland 2021, Barsky et al. 2007), which is why in the baseline model I include interactions between a binary variable equal to one if the PCE sector  $j$  is a durable sector and the monetary policy shock for both the contemporary shock and 12 lags. Since the oil price is volatile and since the central bank can respond directly to oil shocks, in my baseline model I include an interaction between the sector  $j$ 's total cost share in oil  $S_j^O$  and the 12-month change in the WTI oil price  $\Delta P_t^O$  at time  $t-k$ . These

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<sup>21</sup>Standard errors are similar when using heteroskedasticity-consistent robust standard errors that are not robust to auto-correlation (Herbst and Johansen 2021, Montiel Olea and Plagborg-Møller 2021).

additional controls are denoted by  $\Gamma_{h,k}W_{j,t-k}$ . The appendix section B.5 shows the point estimates for robustness checks where the durable good and oil price controls are removed. I also show results where  $\Gamma_{h,k}W_{j,t-k}$  also includes interactions between the sector level-price change frequency and the contemporary and lags of the monetary policy shock.

If aggregate demand responds non-homothetically to monetary policy shocks, then I would expect  $\gamma^{h,0}$  to be positive when the dependent variable is the log-share. A positive coefficient means that products bought more by poor households (the expenditure ratio  $R_j$  is higher) increase in price following a contractionary monetary policy shock compared with other products. Furthermore, an upward sloping relative supply curve implies that  $\gamma^{h,0}$  in the price regression should have the same sign as  $\gamma^{h,0}$  in the demand regression.

#### 4.1.1 Results: Monetary Policy Shock

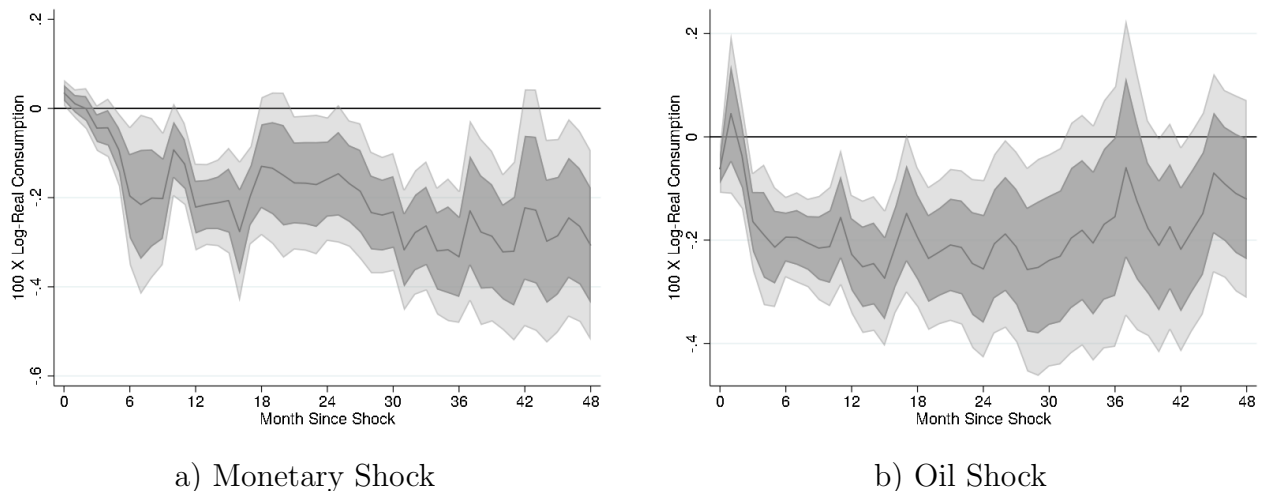
In the model presented in the preceding section, a fall in expenditure causes households to shift their demand to necessities because of non-homothetic preferences. Accordingly, I test directly how the monetary news shocks affect aggregate expenditure using a simple local projection of log-real PCE on a one-standard deviation monetary policy shock (Jordà 2005). I follow Ramey (2016) and include 12 lags of the monetary instrument and 12 lags of the dependent variable. I also include 12 lags of the PCE price level, one-year Treasury yield, 12-month change in WTI oil prices, and the unemployment rate. Figure 8 panel (a) shows that following a one standard deviation monetary policy shock real PCE falls after around 6-months and reaches a trough of around  $-0.33$  percent about 36-months after the monetary policy shock.<sup>22</sup> The appendix section B.4 shows that the 1- and 10 year treasury yields increase in response to the monetary policy shock.

Figure 9 shows the impulse response functions (IRFs) estimated following equation (4.1). Panel (a) shows that aggregate expenditure shifts towards necessity products following a contractionary monetary shock. The IRF peaks at around 0.5 30 months after impact, which means that products with an expenditure ratio 1-point higher than average increase their aggregate share by approximately one half of a percent relative to other products. The IRF on the log-share is positive and statistically significant at the 90 percent level as soon

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<sup>22</sup>For the readers convenience, the dependent variables have been multiplied by 100 prior to estimation.

**Figure 8:** Real Expenditure Falls after Monetary Contractions and Oil Shocks



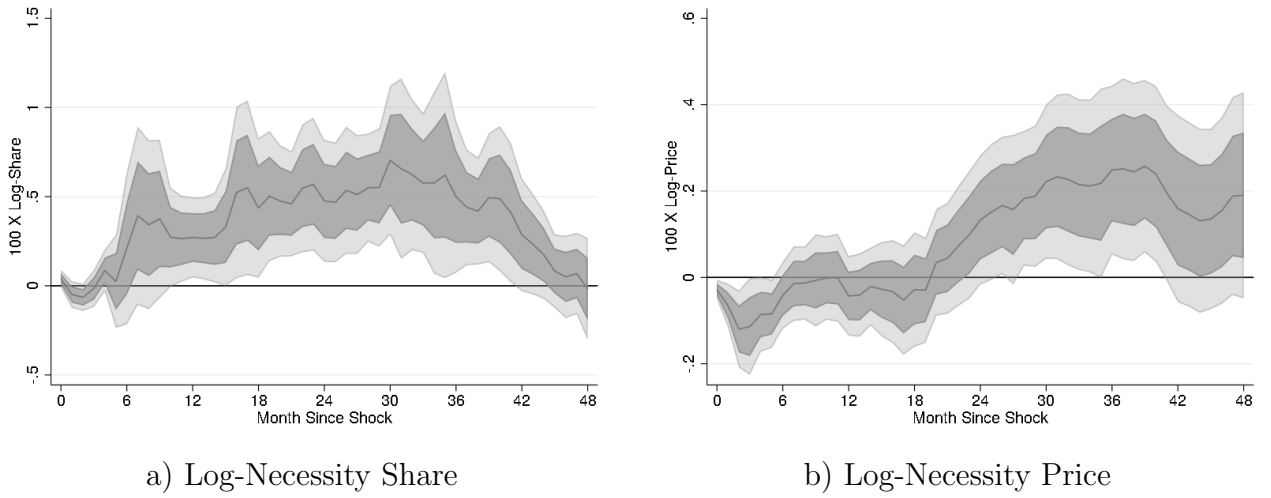
Note: Panel A: data from 1989-2019, Panel B: data from 1976-2023. Estimated coefficients, from Local Projections represent the response of 100 times log-real PCE expenditure to a one-standard deviation monetary contraction or oil price shock using the Bauer and Swanson (2022b) monetary shocks or Känzig (2021) oil shocks respectively. The unit of observation is the month. The dark and light shaded areas represent 90 and 68 percent confidence bands respectively. Standard errors are robust to auto-correlation.

as 12 months after the monetary shock. Panel (b) shows how the relative price of necessity goods increases following the monetary contraction. A product with expenditure ratio 1 point higher than average increases in relative price by around 0.25-percent, which peaks 30-36 months after the monetary policy shock. If we combine the results of the response of expenditure to the monetary policy shock from figure 8 with those in figure 9 it implies that the elasticity of the relative price of a product with an expenditure ratio 1 point higher than average to expenditure is  $-1$ .<sup>23</sup> In the appendix, section B.5 I repeat this analysis using a binary definition of necessity instead of the continuous  $R_j$  measure used here and the results are quantitatively similar. Additional robustness tests in the appendix section B.5 show similar results under a variety of robustness checks including alternate types of monetary policy shocks and alternate specifications.

<sup>23</sup>In principle, one could estimate this directly by using the monetary policy shocks as an instrument for expenditure and then testing how the relative price responds to a change in expenditure; however, this type of analysis gives the econometrician a large-choice set of specifications because in addition to the typical choices of which controls to include the econometrician must choose how many lags of the monetary policy shock should be included as instruments for expenditure; as figure 8 shows expenditure is significantly depressed for several years following the shock.

The empirical results provide evidence for the mechanism presented in the static model. Following shocks that lower aggregate expenditure, aggregate spending shifts towards necessities raising their relative prices. It should be noted, that the aggregate necessity share responds faster empirically than the rise in relative necessity prices, which could be consistent with sticky prices. Sticky prices are not a feature of the static model I presented in section 3, but will be incorporated into the quantitative model in the next section.

**Figure 9:**  $\gamma^{h,0}$ : Necessity Response to Monetary Policy Shock



Note: Data from 1989-2019. Estimated coefficients,  $\gamma^{h,0}$  from Local Projections in equation (4.1) represent the response of the dependent variable to a one-standard deviation monetary contraction using the Bauer and Swanson (2022b) monetary shocks interacted with  $R_j$ . The unit of observation is the PCE sector-month. The dark and light shaded areas represent 90 and 68 percent confidence bands respectively. Standard errors are robust to auto-correlation and are clustered at the monthly level. PCE sectors weighted by their share in pooled aggregate expenditure.

#### 4.1.2 Interest Rate Effects on the Relative Supply Curve

The simple New Keynesian framework ignores potential supply side effects of monetary policy. For example, Barth III and Ramey (2001) argue that monetary policy can impact the cost of working capital, which includes inventories. A contractionary monetary policy shock can lower aggregate supply through increases in the cost of financing working capital, which could shift the relative supply curve if some sectors rely more on working capital than others and would be particularly problematic if it were necessities that relied more on

working capital since that could imply that the increase in the relative necessity price I find in figure 9 is partially due to the shift in the supply curve.<sup>24</sup>

As an alternative to monetary policy shocks, I show in appendix section B.6 that uncertainty shocks also lead to a fall in aggregate expenditure, but importantly lead to lower interest rates. Following an uncertainty shock, relative necessity shares and prices increase and I estimate that the necessity relative price expenditure elasticity is between  $-0.5$  and  $-1$  depending on the type of uncertainty shock considered.<sup>25</sup> These results are very similar to those when using monetary policy shocks and imply that if there is a relative supply effect coming from an increase in interest rates then the relative supply effect is small compared to the effect of the change in expenditure on necessity relative prices.

## 4.2 Aggregate Supply Shock: Oil Price

Oil prices represent a larger fraction of the total cost of low-income household's budgets than high-income households, so even in the absence of the mechanism I present in this paper increases in the cost of oil will have higher inflationary consequences for low-income households (Känzig 2023). However, as I show in figure 8 an oil price shock also lowers real aggregate expenditure, which could lead to additional income effects on necessity relative demand and prices beyond that implied by the higher cost-share of oil of those products.

The main issue with using oil-shocks to test the assumptions of aggregate non-homothetic demand and an upward sloping relative supply curve is that an oil shock should lead to both a shift in the relative demand curve and a shift in the relative supply curve, which makes identification difficult. However, if we can isolate the direct effect of the oil price shock on relative prices (as shown in equation 3.6) then we could control for the shift in the relative supply curve.

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<sup>24</sup>In contrast, if it is luxuries that rely more on working capital then the results in figure 9 would mean that the change in prices coming from the income effect was larger than the shift in prices from the relative supply effect.

<sup>25</sup>I use the VIX index, the economic policy uncertainty shocks from Baker et al. (2019), and the econometric uncertainty shocks from Jurado et al. (2015).

### 4.2.1 Total Response to an Oil Shock

I begin by estimating the overall response of necessity relative shares and prices to an oil shock by estimating a panel local projection with all 148 sectors of the log-share or log-price to a Känzig (2021) oil news shock:

$$x_{j,t+h} = \sum_{k=0}^{12} [\sigma^{h,k} ON_{t-k} \times R_j + \gamma^{h,k} i_{t-k} \times R_j] + \sum_{l=1}^{12} \left[ \sum_{y \in \{s,p\}} (\beta^{y,l} y_{j,t-l}) + \beta^{O,l} \Delta P_{t-l}^O \times S_j^O \right] + \delta_t + \psi_j + \alpha_{j,t+h}. \quad (4.2)$$

The coefficient of interest is  $\sigma^{h,0}$  (the coefficient of the interaction of the contemporary oil price news shock  $ON_t$  and expenditure ratio  $R_j$ ). In order to isolate the effect of the oil news shock from monetary policy responses, I also include the contemporary and 12 lags of the monetary policy news interaction  $\gamma^{h,k} i_{t-k} \times R_j$ . I include time and PCE sector fixed effects and a year of lags of both dependent variables as in the earlier local projections. To isolate the effect of the contemporary shock, I also include a year of lags of previous 12-month changes in oil prices  $\Delta P_{t-l}^O$  interacted with that sectors cost share of oil  $S_j^O$ .

### 4.2.2 Expenditure Induced Response to an Oil Shock (Indirect)

I condition the response to the oil news shock at time  $h$  on the cumulative percent change in oil price from time  $t$  to  $h$  interacted with the sector oil share in order to separate out the indirect expenditure induced response to the oil news shock:

$$x_{j,t+h} = \sum_{k=0}^{12} [\xi^{h,k} ON_{t-k} \times R_j + \gamma^{h,k} i_{t-k} \times R_j] + \kappa^h \Delta|_{t-1}^{t+h} P^O \times S_j^O + \sum_{l=1}^{12} \left[ \sum_{y \in \{s,p\}} (\beta^{y,l} y_{j,t-l}) + \beta^{O,l} \Delta P_{t-l}^O \times S_j^O \right] + \delta_t + \psi_j + \alpha_{j,t+h}. \quad (4.3)$$

Where,  $\xi^{h,0}$  is the coefficient of interest.  $\Delta|_t^{t+h} P^O$  is the cumulative percent change in the WTI oil price from time  $t-1$  to  $t+h$ , and  $S_j^O$  is the total cost share of oil in production

for sector  $j$ .

The total oil cost share in production,  $S_j^O$ , from the BEA's input and output tables is an estimate of the increase in production costs for sector  $j$  after a one unit increase in the cost of oil. The inclusion of  $\kappa^h \Delta|_{t-1}^{t+h} P^O \times S_j^O$  then orthogonalizes the estimates of  $\xi^{h,k}$  to increases in costs for industry  $j$  coming from the direct cost of the oil increase assuming that (1) the estimates from the BEA are correct over time and (2) the dynamics of the oil price change on production costs are similar across industries. The BEA's estimates of the oil cost share of commodities in the total requirement tables do change and while I check for robustness using the 2007 and 2017 input output tables (baseline uses the 2012 input output tables) the  $S_j^O$  estimates may not reflect the actual cost share of oil for PCE sectors in early periods such as the 1970s, which would violate (1). For assumption (2), the BEA's estimate includes all of the direct input costs of "Oil and Natural Gas Extraction," as well as all network costs of oil from upstream providers, however, Minton and Wheaton (2023) show that downstream firms can be slow to adjust prices in response to input costs of upstream providers, so while  $S_j^O$  may correctly reflect differences in the the cost share of oil eventually, in the periods immediately after the oil shock these cost shares may be too high for sectors that are more downstream from oil production. Finally, given that assumptions (1) and (2) hold and we can decompose the direct and indirect effects of the oil shock as in equation 3.6, the static model in the previous section assumes perfect competition; if markups are higher/lower for necessities then  $\xi^{h,0}$  would be biased upward/downward.

For the relative price results,  $\xi^{h,0}$  is the sum of both the indirect effect due to the move along the relative demand curve  $MD$  and the shift of the relative demand curve  $SD$ . The shift of the relative demand curve is due to non-homothetic preferences and only  $SD$  is comparable to the results in the previous section with monetary policy shocks, where we assumed that the relative supply curve did not shift. However, as I show below, for oil price shocks I estimate that  $MD$  is quite small so  $\xi^{h,0} \approx SD$ . If  $MD$  is positive then the results I find for  $\xi^{h,0}$  would be an underestimate of the change in the relative prices of necessities due to the expenditure induced non-homothetic demand shift.



### 4.3 Results: Oil Price Shock

Figure 10 shows the estimation results of the effect of the oil price shock on necessity relative shares and prices. Panel a) and b) show the total response to the oil price shock  $\sigma^{h,0}$ . The relative share of necessities rises by around 0.3 percent shortly after impact and the relative necessity prices increases by nearly 0.2 percent on impact before increasing to over 0.3 percent a few months after the shock. The total effect on relative necessity prices stabilizes at around 0.15. The indirect effect on relative necessity shares, panel c), is essentially the same as the direct effect, which implies that very little of the shift in necessity demand is due to the change in the price of oil coming from differences in oil production shares between sectors, which could mean that short-run demand for oil intensive goods is quite inelastic and the move along the relative demand curve ( $MD$ ) due to the oil price shock is small.<sup>26</sup>

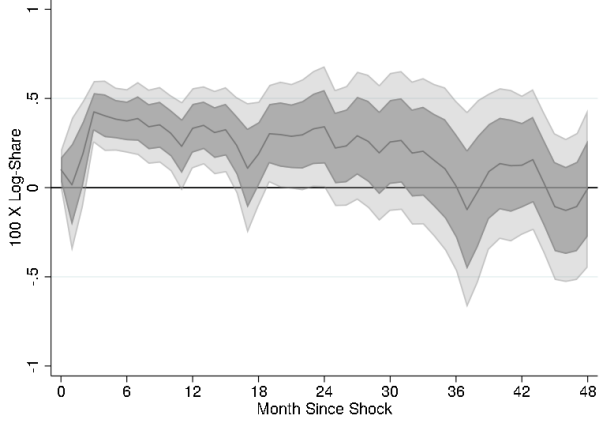
The indirect effect on relative necessity prices, panel d), is above 0.1 percent in the months shortly after impact before stabilizing a bit below 0.1 percent. Slightly less than half of the total effect of oil prices on necessity relative prices is due to the indirect expenditure induced effect and the relative necessity price expenditure elasticity is approximately  $-0.5$ .

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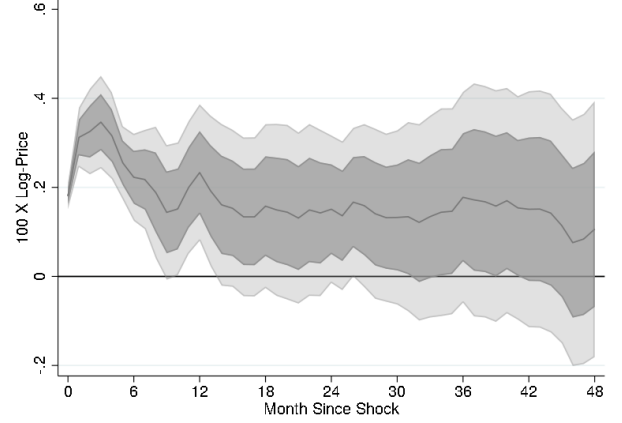
<sup>26</sup>Estimates for the demand elasticity of gasoline tend to be very low even if they have risen a bit in recent data.(Brons et al. 2008, Goetzke and Vance 2021).

**Figure 10: Necessity Response to Oil Shock**

$\sigma^{h,O}$ : Total Response to Oil Shock (Direct and Indirect)



a) Log-Necessity Share

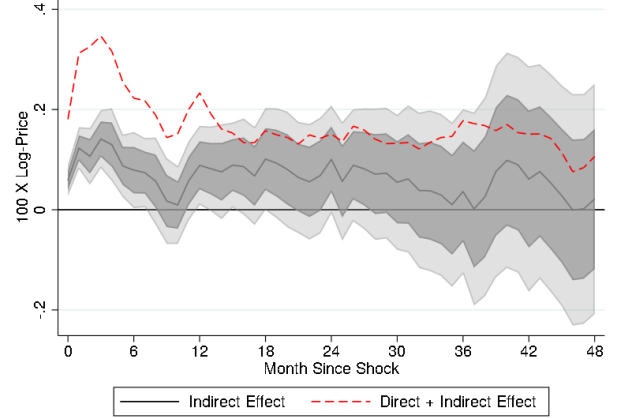


b) Log-Necessity Price

$\xi^{h,O}$ : Expenditure Induced Response to Oil Shock (Indirect)



c) Log-Necessity Share



d) Log-Necessity Price

Note: Data from 1976-2023. Estimated coefficient from Local Projections represent the response of the dependent variable to a one-standard deviation Känzig (2021) interacted with  $R_j$ . Panels c) and d) control for the interaction between the oil price at horizon  $h$  and the PCE sector's oil share, as well as for the contemporaneous (time 0) and lags of the monetary policy shock interacted with  $R_j$ . The unit of observation is the PCE sector-month. The dark and light shaded areas represent 90 and 68 percent confidence bands respectively. Standard errors are robust to auto-correlation and are clustered at the monthly level. PCE sectors weighted by their share in pooled aggregate expenditure.

## 5 New Keynesian Model with Non-homothetic Consumption Preferences

I have already formally presented the cyclical demand shift mechanism and shown that this mechanism is qualitatively consistent with the empirical results. This section shows that the theoretical results also quantitatively match the cyclical behavior of necessity prices and aggregate shares in the data. I include non-homothetic consumption preferences in a two-sector New Keynesian model with sticky wages and calibrate this model to the U.S. economy in 2005-06. I then use the model to examine the welfare consequences of the cost-of-living channel of recessions for low- and high-income households.

### 5.1 Households

#### 5.1.1 Intratemporal Consumption Choice: The Almost Ideal Demand System

Household preferences follow the Almost Ideal Demand System (AIDS) first introduced by Deaton and Muellbauer (1980). I choose the AIDS for two reasons. First, the model relies on aggregate demand shifts, and since the AIDS is a form of PIG-Log (Price Invariant Generalized Logarithmic) preferences, they are within the Generalized Linear class of preferences and can be aggregated (Muellbauer 1975). Aggregation is a clear advantage over other types of non-homothetic demand systems, such as the non-homothetic CES (constant elasticity of substitution) system presented in Comin et al. (2021). AIDS aggregation properties allow me to estimate aggregate parameters using micro-data since the parameters for the representative and micro-level households are the same. The second reason, is that the AIDS was originally designed to be extremely flexible; in fact, it is a first-order approximation to any demand system (Deaton and Muellbauer 1980).<sup>27</sup>

The functional form for the household level indirect utility function is

$$V(X^h, \mathbf{p}) = \left( \frac{X}{a(\mathbf{p})} \right)^{1/b(\mathbf{p})}, \quad (5.1)$$

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<sup>27</sup>A disadvantage is that the AIDS is not generally regular. There are levels of expenditure and prices for which the AIDS is not a valid utility function. However, this is not an issue for the calibration and expenditure levels that I study.

where  $a(\mathbf{p})$  and  $b(\mathbf{p})$  are price aggregators over a vector of sector level prices  $\mathbf{p}$  defined by:

$$\log(a(\mathbf{p})) = a_0 + \sum_k a_k \log(p_k) + \frac{1}{2} \sum_j \sum_k \gamma_{jk} \log(p_j) \log(p_k) \quad (5.2)$$

$$\log(b(\mathbf{p})) = \sum_j \beta_j \log(p_j) \quad (5.3)$$

where  $\gamma_{jk}$  are cross-price semi-elasticities and  $\beta_j$  are expenditure semi-elasticities. Parameters have the following restrictions:  $\sum_{j=1}^N a_j = 1$ ,  $\sum_{j=1}^N \beta_j = \sum_{j=1}^N \gamma_{jk} = 0$  and  $\gamma_{ij} = \gamma_{ji} \forall i, j$ .

The indirect utility function equation (5.1) has a corresponding cost function:<sup>28</sup>

$$\log c(u_h^0, \mathbf{p}) = \log(a(\mathbf{p})) + (b(\mathbf{p})) \log(u_h). \quad (5.4)$$

The cost function shows that households must pay some cost for subsistence level consumption  $\log(a(\mathbf{p}))$ , where  $a(\mathbf{p})$  is a homothetic translog price aggregator. The second aggregator,  $b(\mathbf{p})$  introduces non-homotheticities into the cost-function. A household's cost to reach a higher level of utility (expenditure) increases with  $b(\mathbf{p})$ . This specification allows me to construct the theoretically consistent non-homothetic price index for a household with fixed utility  $u_h$ :

$$\log P(\mathbf{p}^1, \mathbf{p}^0, u_h^0) = \log \left( \frac{a(\mathbf{p}^1)}{a(\mathbf{p}^0)} \right) + \log \left( u_h^{b(\mathbf{p}^1) - b(\mathbf{p}^0)} \right) \quad (5.5)$$

The greater the household's utility (expenditure)  $x^h$ , the higher is the welfare gain from reductions in  $b(\mathbf{p})$ . Similarly, households with a low-expenditure level have changes in the cost of living closer to changes in the subsistence price index  $a(\mathbf{p})$ .

Roy's identity applied to equation (5.1) yields the following Marshallian demand share for products in sector  $j$ :

$$s_j = a_j + \sum_k \gamma_{jk} \log(p_k) + \beta_j \log \left( \frac{x^h}{a(\mathbf{p})} \right). \quad (5.6)$$

A household's share of expenditure on a particular product  $j$  is dependent on prices and real expenditure level. The demand share increases with real expenditure if  $\beta_j > 0$  (luxuries). The household's expenditure elasticity for good  $j$  is  $1 + \frac{\beta_j}{s_j}$ , while the cross price elasticity is

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<sup>28</sup>This functional form differs from the cost function in Deaton and Muellbauer (1980) because of a slight change in the definition of  $b(\mathbf{p})$ . If written out entirely, the two cost functions are identical

$\delta_{jk} + \frac{\gamma_{jk} - \beta_j(\alpha_j + \sum_k \gamma_{jk} \log(p_k))}{s_j}$  where  $\delta_{jk}$  is the Kronecker delta term.

Household intratemporal aggregate demand can be represented completely by a representative household. However, unlike homothetic preferences, the representative consumer does not have an expenditure level equal to the aggregate household. In the non-homothetic case, the representative consumer's expenditure level must increase with the level of expenditure inequality in the economy. A less equal distribution of expenditure means that high-expenditure households command a larger portion of aggregate spending, which means that the aggregate share spent on luxuries is higher than in an otherwise equivalent economy with lower expenditure inequality. A collection of households with PIG-Log preferences can be represented by a household with income  $X^r = X^{mean} \exp\left(\sum \frac{x^h}{X^{mean}} \ln\left(\frac{x^h}{X^{mean}}\right)\right)$  where the term on the right  $\left(\sum \frac{x^h}{X^{mean}} \ln\left(\frac{x^h}{X^{mean}}\right)\right)$  is the Theil index of the expenditure distribution, which increases with expenditure inequality Muellbauer (1975), Deaton and Muellbauer (1980).

### 5.1.2 Intertemporal Consumption Choice and Labor Supply

Each household chooses consumption expenditures to maximize their sum of discounted indirect utility over time:

$$\mathbb{E}_0 \sum_{t=0} \beta^t [F(V(X_t^h, \mathbf{p}_t)) - g(H_t^h)], \quad (5.7)$$

where  $g()$  is the disutility of labor and  $H$  is hours worked.  $F(\cdot)$  is taken to be the isoelastic utility function:

$$F(y) = \frac{y^{1-\eta} - 1}{1 - \eta}.$$

One feature of isoelastic preferences is, the elasticity of intertemporal substitution is generally constant. However, that is not the case in this model. Following Browning (2005), I define the elasticity of intertemporal substitution as:

$$EIS = -\frac{\nu_x(X_t, \mathbf{p}_t)}{X_t \nu_{xx}(X_t, \mathbf{p}_t)},$$

where  $\nu(X_t, \mathbf{p}_t) = F(V(X_t^h, \mathbf{p}_t))$ . So in this model the elasticity of intertemporal substitution is  $-\frac{b(\mathbf{p}_t)}{1-\eta-b(\mathbf{p}_t)}$ , which varies with the level of relative prices in the economy (Crossley and Low 2011, Attanasio and Weber 1995). When relative prices for luxuries are higher, this increases the concavity of the indirect utility function making further increases in utility more difficult, which raises the elasticity of intertemporal substitution.

One important thing to note is, while the elasticity of intertemporal substitution is dependent on relative prices, it does not depend on the household's income or expenditure level. The household's disutility of labor also does not depend on household expenditure or income (in this model). So, household intertemporal and labor supply decisions can also be characterized by a representative household.<sup>29</sup> In practice, I solve for equilibrium prices and aggregate shares using the representative household. I can then back out household level price indices given aggregate prices. This approach has the advantage of being able to study welfare effects with heterogeneous consumption bundles using the large toolbox of solution methods for representative agent models.

The representative household works for wages  $W_t$  and can invest in a one-period nominally riskless bond  $B_t$  that pays one monetary unit in the next period at price  $Q_t$ . The resulting household budget constraint and the no-Ponzi scheme condition are shown below:

$$\begin{aligned} X_t + Z_t Q_t B_t &\leq B_{t-1} + W_t H_t + D_t \\ \lim_{T \rightarrow \infty} \mathbb{E}_t(\Lambda_{t,T} B_t) &\geq 0. \end{aligned} \tag{5.8}$$

In the above expression,  $D_t$  is a dividend from firm profits and  $\Lambda_{t,T} = \beta^{T-t} \frac{V_{X,T}}{V_{X,t}}$  where  $\beta$  is the discount factor.  $Z_t$  is an interest rate wedge shock that is distributed *i.i.d* and acts to dampen or increase a household's per-period expenditure.

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<sup>29</sup>While there has been extensive work showing that households intertemporal responses vary based on income level (see Kaplan, Moll, Violante (2018) for an example), heterogeneous intertemporal responses is not the key feature of this paper. Some macroeconomic policies such as the 2020 and 2021 stimulus checks could have first-order effects on relative prices, as only low to moderate-income individuals were given checks. If low-income household expenditure increases sufficiently after such a policy then the Theil Index could rise enough to partially offset aggregate increases in expenditure.

The household's optimization problem and budget constraint yield the following Euler Equation:

$$Q = \beta \mathbb{E} \left[ \frac{a(\mathbf{p})b(\mathbf{p})}{a(\mathbf{p}')b(\mathbf{p}')} \frac{\left(\frac{X'}{a(\mathbf{p}')}\right)^{\frac{1-\eta}{b(\mathbf{p}')} - 1}}{\left(\frac{X}{a(\mathbf{p})}\right)^{\frac{1-\eta}{b(\mathbf{p})} - 1}} \frac{1}{Z} \right]. \quad (5.9)$$

I assume that the disutility of labor takes the familiar form (with  $\phi$  the inverse of the Frisch elasticity of labor supply):

$$g(H_t) = \varphi \frac{H_t^{1+\phi}}{1+\phi}. \quad (5.10)$$

However, households do not decide how much labor to provide. Rather, they allow a labor union to bundle and sell their labor, which introduces sticky wages and nominal rigidity (see Erceg et al. (2000), Auclert et al. (2018), Auclert et al. (2020), Broer et al. (2020), Ramey (2020)). The mathematical appendix shows that the Wage-Phillips curve is:

$$\begin{aligned} (1 + \pi_t^w) \pi_t^w = & \beta \mathbb{E}_t [(1 + \pi_{t+1}^w) \pi_{t+1}^w] \\ & + \left( \frac{\epsilon_w}{\psi_w} \right) \left( \varphi H_t^\phi - \left( \frac{\epsilon_w - 1}{\epsilon_w} \right) \frac{W_t}{a(\mathbf{p}_t)b(\mathbf{p}_t)} \left( \frac{X_t}{a(\mathbf{p}_t)} \right)^{(\frac{1-\eta}{b(\mathbf{p}_t)} - 1)} \right) \end{aligned} \quad (5.11)$$

## 5.2 Firms

There is a necessity and a luxury sector. Each sector has flexible prices and perfect competition. Firms have concave production over labor; they can scale up labor in the short run, but other factors of production are constrained. The production function for the representative firm in sector  $i$  is:

$$Y_t(i) = A_{it} H_t(i)^{(1-\alpha)} \quad \alpha \in (0, 1). \quad (5.12)$$

Firms sell their good for price  $p_t(i)$  in a competitive market. Firms take prices and wages as given. Firm optimization implies that

$$p_t(i) = \frac{W_t}{(1-\alpha) A_{it} H_t(i)^\alpha}. \quad (5.13)$$

This equation yields a relative supply curve, that is upward sloping:

$$\frac{p_t(i)}{p_t(j)} = \frac{A_{jt}H_t(j)^\alpha}{A_{it}H_t(i)^\alpha}. \quad (5.14)$$

The elasticity of marginal cost to an increase in output, which governs the slope of the relative supply curve, is  $\frac{\alpha}{1-\alpha}$ .

### 5.3 Equilibrium

An equilibrium for this model is defined as a series of prices  $\{W_t, \mathbf{p}_t\}$  and quantities  $\{Y_{N,t}, Y_{L,t}, H_t, \mathbf{h}_{j,t}, X_t, D_t, \mathbf{s}_{j,t}\}$  such that households optimize intertemporally and intratemporally given prices, the union chooses labor to maximize household utility, firms maximize profits given prices, and markets clear.<sup>30</sup>

### 5.4 Calibration

The two most important parameters for the model are (1)  $\beta_L = -\beta_N$  the degree of non-homotheticity, and (2)  $\alpha$ , which is one minus the labor share. The first is important since it governs the degree to which representative household spending shifts between sectors over the course of the business cycle. For example, a value of  $\beta_L = -\beta_N = 0$  would imply that the household has homothetic preferences, and macroeconomic shocks would not affect the relative demand for necessities or luxuries. The second,  $\alpha$ , controls the price response of the expanding sector.

In the baseline calibration, I choose  $\beta_L$  so that the steady-state necessity share for low- and high-income households in the model matches that for low- and high-income households in the data. In an alternative calibration, I estimate  $\beta_L$  and the other (AIDs) parameters directly from the microdata; the results of this alternative calibration are in the appendix.

There are a variety of estimates of  $\alpha$ , the capital share, in the literature. These can range from as low as 0.16, the implied value based on the estimated elasticity of marginal

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<sup>30</sup>There is also a central bank that uses a Taylor rule to set interest rates:

$$-\log(Q_t) = i_t = F(\pi_t^w) \quad (5.15)$$

where  $F(\cdot)$  is increasing in wage inflation.



**Table 5:** Baseline Calibration

Parameter	Desc.	Value	Source
$\alpha$	Capital share	0.26	(Midpoint Fernald (2014) and Feenstra and Weinstein (2017))
$\beta$	Discount rate	.99	
$1/\eta$	EIS at steady state	0.5	
$\phi$	Inverse Frisch elasticity	1	
$\psi_w$	Wage adjustment penalty	20.7	(Wage Phillips Slope 0.29 Galí and Gambetti (2019))
$\epsilon_w$	Substitutability of labor	6	(Colciago 2011)
$\beta_L$	Degree of non-homotheticity	0.29	(Target High- and Low- income steady state necessity shares)
$\gamma_{LN}$	Cross-price semi-elasticity	0.95	(Feenstra and Weinstein 2017)
$\alpha_N$		2.9	(Target necessity share 0.53)

cost to quantity produced from Feenstra and Weinstein (2017), to as high as 0.37 estimated directly in Fernald (2014). For the baseline specification, I choose  $\alpha$  as the midpoint of these extreme values ( $\alpha = 0.26$ ). Alternate calibrations with other values of  $\alpha$  are included in the appendix.

The remaining parameters I take either from the literature, or from targeting the steady-state expenditure and necessity share of the representative agent to match representative expenditure and aggregate necessity shares in the period immediately preceding the Great Recession (2005-2006).<sup>31</sup> I target the calibration, so that in the steady-state necessity and luxury prices are equal (which means that the Elasticity of intertemporal substitution is equal to  $1/\eta$ ). Table 5 shows the chosen calibration.

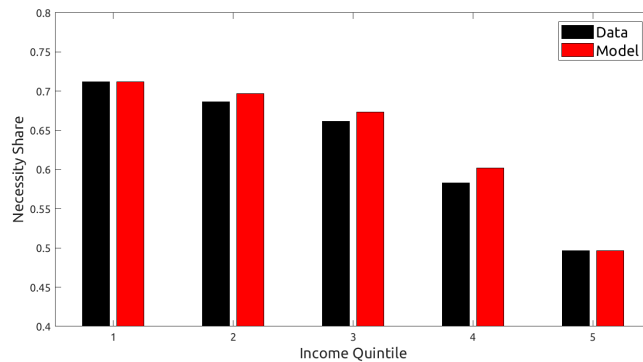
## 5.5 Results

How well can the calibrated model explain the distribution of household consumption and historical changes in necessity shares and prices? I start by comparing the steady-state necessity shares in the model with those in the data. While I targeted the aggregate steady-state share of necessities and those from the top and bottom income groups, the other income groups' necessity share was not targeted. Figure 11 shows the model implied necessity shares

<sup>31</sup>Representative expenditure in the data is average expenditure multiplied by the calculated Theil index.

for the five different income groups alongside their actual values in the data (2005-06). In the data, low-income households spend around 70 percent of their budget on necessities compared with around 50 percent for high-income households, which by design, the model matches exactly. The model also matches the necessity shares for the non-targeted income groups within 2 percentage points.

**Figure 11:** Model and Data: Necessity Shares by Income Group



Note: Data from 2005 to 2006. Model income-group shares at steady state. Author targeted calibration so model necessity shares for the top and bottom income quintiles would match empirical necessity shares. Necessity shares for the middle income quintiles are untargeted.

### 5.5.1 Historical Simulation

How well does the model predict necessity prices and shares over time? As a validation exercise, I shock the model with a series of i.i.d. interest wedge shocks so that the expenditure series in the model exactly matches the filtered real personal consumption series from the Bureau of Economic Analysis. I then compare the necessity share and price series in the simulated model with their filtered counterparts in the data. Figure 12 shows the results of this simulation. The data series of prices and shares excludes the volatile energy and transportation sectors.

The top panel shows the path of both model and data expenditure from 1994 to 2021. The second panel shows the untargeted model necessity share series compared to the data.<sup>32</sup>

<sup>32</sup>The expenditure share series begins in 1991, but filtering necessitates dropping the first few years of data.

Similar to the data, the model necessity share series falls during the late 1990s, rises around the 2001 recession, falls again during the housing boom, increases drastically during the Great Recession, falls again in the subsequent recovery and then rises during the COVID-19 pandemic. The time series in the model and data are highly correlated (0.55), and a simple regression of the data series on the model series yields a coefficient of 0.6.

The bottom panel compares relative necessity prices in the data with the cyclical component of the composite necessity price in the data. I use a balanced sample of products with continuous price data from 1987-2021 (this is the red series in figure ??). The data and the model series match each other quite closely, however the model overstates the fall in necessity prices during the dot-com boom (late 1990s) and the rise in necessity prices during the COVID-19 recession. A simple regression of the data series on the model series yields a coefficient of 0.54.<sup>33</sup> I conclude that the model is effective at predicting the cyclical path of relative necessity shares and prices.

### 5.5.2 Welfare Implications

What are the welfare implications of this model? In this model, the expenditure inequality of households is fixed at the steady-state level. However, households price indices can diverge since low-expenditure households spend more of their budget in the necessity sector. How much can this divergence matter? Table 6 shows the difference in the non-homothetic price index (equation (5.5)) between households with expenditure matching expenditure in the bottom income quintile compared with households with expenditure matching expenditure in the top income quintile. During the Great Recession, the price index of poor households increased by 0.85 percent more than rich households. This result closely matches the difference in the change in core inflation in the data over this same period (0.86 see figure ??). Failing to incorporate changes in the price index could lead to large underestimates of the change in consumption inequality over the Great Recession. For example, Krueger et al. (2016) use the Panel Study of Income Dynamics and find that household consumption in the first wealth quintile fell by approximately 0.3 percent more than consumption in the highest quintile from 2006-2010. A back of the envelope calculation suggests that the change in real

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<sup>33</sup>The correlation coefficient is 0.44.

consumption is  $\Delta \ln \left( \frac{c}{p} \right) = \Delta \ln(c) - \Delta \ln(p) = 0.0115$  or 1.15 percent, which is nearly a fourfold increase compared with Krueger et al. (2016).

While the model predicts that this price index gap will eventually close (as the model returns to steady-state), the price index of the lowest income quintile remains elevated during the slow recovery (GDP per-capita did not return to pre-Great Recession levels until 2013Q1). The average difference in the cost of living from the beginning of the great recession until GDP per capita recovered is 0.5 percentage points.

**Table 6:** Welfare Difference Low v. High Income Households

Panel A: Difference in Price Index		
Time Period	End Period	Average
Great Recession (2007Q3-2009Q2)	0.85	0.42
Recession to Recovery (2007Q3-2012Q4)	0.12	0.51
Panel B: Expenditure Equivalent Welfare Loss		
	Low Income	High Income
Expenditure Equivalent Welfare	0.59 %	0.48 %
Ratio		1.22

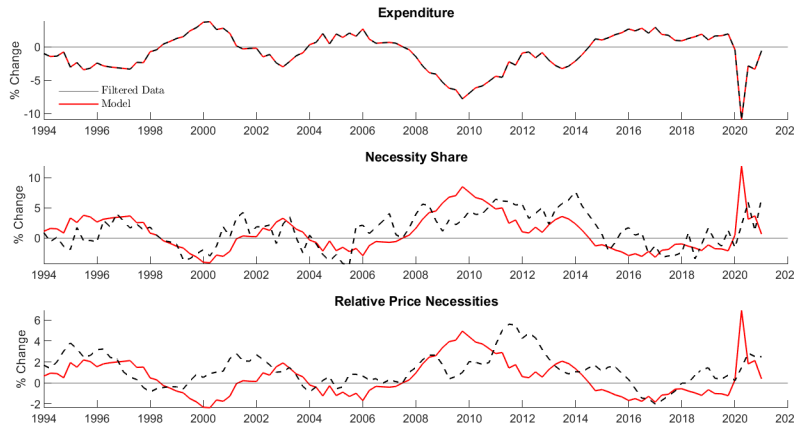
Note: Price index difference is defined as the percentage point difference in the change of the cost-of-living for Q1 versus Q5 households as calculated in the model. Expenditure equivalent welfare is the present discounted value of *all* future expenditure the household would be willing to forgo in exchange for avoiding recessionary shock.

Next, I calculate the expenditure equivalent welfare loss of the Great Recession for a household in the lowest income group and the highest. This measure is the present discounted value of all future expenditure streams that the household would relinquish in order to avoid the Great Recession:

$$\mathbb{E}^{No \text{ Recession}} \left[ \sum_{t=0}^{\infty} \beta^t (V((1 - \xi)X_{ht}, \mathbf{p}_t) - g(H_t)) \right] = \mathbb{E}^{Recession} \left[ \sum_{t=0}^{\infty} \beta^t (V(X_{ht}, \mathbf{p}_t) - g(H_t)) \right] \quad (5.16)$$

where  $\xi$  is the share of all future expenditure the household would relinquish so that the present discounted value of all future utility streams is equal in the counterfactual world where the Great Recession never happens. Table 6 shows that low-income households would be willing to give up 0.59% of all future expenditure, while high-income households would relinquish only 0.48%, a difference (as expressed by the ratio) of approximately 22%. A

**Figure 12:** Model v. Data: Historical Simulation



Note: Author targeted shock to match expenditure data (top panel). Necessity share and relative necessity price are untargeted. Data is filtered following Hamilton (2018) and excludes energy.

similar model where the level of non-homotheticity ( $\beta_L$ ) is set to 0 results in no difference in welfare loss between low- and high-income households.

## 6 Conclusion

In this project, I present new evidence on the cyclical behavior of necessity and luxury prices. I find that the the inflation rate and aggregate shares of products bought relatively more by low-income households are counter-cyclical. I show that these facts can be rationalized using a model with non-homothetic preferences and a concave production possibility frontier and test these assumptions using monetary policy and oil shocks. A quantitative model can explain around half of the cyclical variation of necessity prices and shares. I find that recessions can be more costly for low-income households as their price index increases relative to the price-index of other households.

It is important to note that this project studies changes in sector-level prices rather than prices within a sector; e.g. furniture is a category made up of many different micro-products each with their own quality and prices. This project also ignores product entry and exit, which could also affect income-level cost-of-living (Feenstra 1994). To the extent

that cyclical demand shifts occur within product categories, causing price increases for low-quality products or changes in product variety (at the business cycle frequency) is a topic for future research.<sup>34</sup>

This study also has ramifications for the measurement of aggregate changes in the cost of living. For example, in the measurement of the CPI, the BLS uses the CEX to weigh product sectors so they are representative of spending by the average household. However, these weights are updated with a lag (currently of up to two years). Since my study shows that *aggregate* spending shifts to necessities during recessions, that means that the CPI underweights necessities in recessions and overweights them during expansions. This result implies that measurement of inflation via the CPI is potentially biased downward during both recessions (when necessity prices are rising more rapidly) and expansions (when luxury prices are rising more rapidly).

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<sup>34</sup>Jaimovich et al. (2019) show that household engage in quality downgrading within sectors during the Great Recession.

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## A Mathematical Appendix

### A.1 Proof of Proposition 1

**Lemma 1** *If  $F(H) : [0, \infty) \rightarrow [0, \infty)$  is homogeneous of degree  $k \in (0, 1)$  then  $\frac{\partial \frac{F'(H_j)}{F'(H_i)}}{\partial \frac{F(H_i)}{F(H_j)}} > 0$ .*

First I show that a function that is homogeneous of degree  $k \in (0, 1)$  is strictly increasing.

Suppose  $H_i > H_j$  then:

$$F(H_i) = H_i^k F(1) > H_j^k F(1) = F(H_j)$$

For notational convenience, let  $Y_i := F(H_i)$ . By Euler’s Homogeneous Function Theorem,  $F(H_i) = F'(H_i)H_i$ , which implies that:

$$\begin{aligned} \frac{F'(H_j)}{F'(H_i)} &= \frac{Y_j}{Y_i} \left( \frac{H_i}{H_j} \right) \\ &= \frac{Y_j}{Y_i} \left( \frac{F^{-1}(Y_i)}{F^{-1}(Y_j)} \right), \end{aligned}$$

where the inverse function must exist since  $F$  is strictly increasing. Next, I take the derivative with respect to the output ratio:

$$\frac{\partial}{\partial \frac{F(H_i)}{F(H_j)}} \frac{F'(H_j)}{F'(H_i)} = \frac{Y_j}{Y_i} \frac{\partial}{\partial \frac{F(H_i)}{F(H_j)}} \left( \frac{F^{-1}(Y_i)}{F^{-1}(Y_j)} \right) - \frac{F^{-1}(Y_i)}{F^{-1}(Y_j)} \quad (\text{A.1})$$

Since the inverse of a homogeneous function of degree  $k$ , is a homogeneous function of degree  $1/k$  it follows that:

$$\frac{\partial}{\partial \frac{Y_i}{Y_j}} \left( \frac{F^{-1}(Y_i)}{F^{-1}(Y_j)} \right) = \frac{\partial}{\partial \frac{Y_i}{Y_j}} \left( \left( \frac{Y_i}{Y_j} \right)^{1/k} \frac{F^{-1}(1)}{F^{-1}(1)} \right) \quad (\text{A.2})$$

$$= \frac{1}{k} \left( \frac{Y_i}{Y_j} \right)^{(1-k)/k}. \quad (\text{A.3})$$

By substituting equation (A.3) into equation (A.1) I find that:

$$\begin{aligned} \frac{\partial}{\partial \frac{F(H_i)}{F(H_j)}} \frac{F'(H_j)}{F'(H_i)} &= \frac{Y_j}{Y_i} \frac{1}{k} \left( \frac{Y_i}{Y_j} \right)^{(1-k)/k} - \left( \frac{Y_i}{Y_j} \right)^{1/k} \\ &= \left( \frac{Y_i}{Y_j} \right)^{1/k} \left( \frac{1}{k} - 1 \right), \end{aligned}$$

which is  $> 0$  if and only if  $k < 1$ . ■

**Corollary 1** *If  $F(H) : [0, \infty) \rightarrow [0, \infty)$  and  $G(H) : [0, \infty) \rightarrow [0, \infty)$  are both homogeneous of degree  $k \in (0, 1)$  then  $\frac{\partial \frac{G'(H_j)}{F'(H_i)}}{\partial \frac{F(H_i)}{G(H_j)}} > 0$ .*

This proof follows from the proof above, except replace  $\frac{F^{-1}(1)}{F^{-1}(1)}$  in equation (A.2) with  $\frac{F^{-1}(1)}{G^{-1}(1)}$ , which implies that:

$$= \frac{F^{-1}(1)}{G^{-1}(1)} \left( \frac{Y_i}{Y_j} \right)^{1/k} \left( \frac{1}{k} - 1 \right),$$

■

**Proposition 1** *In a two-sector competitive economy with a representative household that has preferences satisfying equation (3.4), production function in each sector  $F_i(H_i) : [0, \infty) \rightarrow [0, \infty)$  both homogeneous of degree  $k \in (0, 1)$  and standard market clearing conditions, then*

*an decrease/increase in household expenditure will lead to an increase/decrease in the relative price of necessities.*

Due to market clearing, it follows that

$$C^i(X, p_N, p_L) = F_i(H_i) \quad \forall i$$

From equation (3.4) we know that

$$\frac{\partial}{\partial X} \frac{C^L(X, p_N, p_L)}{C^N(X, p_N, p_L)} > 0.$$

This implies that:

$$\frac{\partial}{\partial X} \frac{F_L(H_L)}{F_N(H_N)} = \frac{\partial}{\partial X} \frac{Y_L}{Y_N} > 0. \quad (\text{A.4})$$

Relative prices can be expressed as:

$$\frac{p_L}{p_N} = \frac{F_{N,H}(H_N)}{F_{L,H}(H_L)}$$

From lemma and corollary 1, we get that:

$$\frac{\partial}{\partial \frac{Y_L}{Y_N}} \frac{F_{N,H}(H_N)}{F_{L,H}(H_L)} > 0. \quad (\text{A.5})$$

Combining equation (A.4) with equation (A.5) and the chain-rule implies that:

$$\frac{\partial}{\partial X} \frac{p_L}{p_N} > 0$$

So the price of the expanding sector (luxuries in this case) must increase. ■

## A.2 A Note on Aggregation

In general, it is not true that if micro-households have non-homothetic preferences then the aggregate household will also have non-homothetic preferences of the same form. Very few types of non-homothetic preferences are Gorman-Polar (Stone-Geary is a notable exception), so these type of preferences cannot simply be added up across households to create an aggregate household with the same preference structure and parameters as the micro households (Muellbauer 1975).

Muellbauer (1975) shows that a necessary and sufficient condition for there to exist an income/expenditure level such that a representative household with that income/expenditure level to have preferences identical to the average of all households is that households must have Generalized Linear preferences. The expenditure/income of a slightly less general version of these preferences, Price Independent Generalized Linear is shown to depend positively on both aggregate income/expenditure and the inequality of the income/expenditure distribution. Intuitively, the reason is that in a more unequal economy, all else being equal, will have a higher portion of aggregate income/expenditure concentrated in a few hands, which means that more luxuries will be consumed. Hence, the representative household should have higher income/expenditure than those implied by the aggregate expenditure in the economy.

If the representative household proceeds to purchase relatively more necessity goods, then these purchases will cause necessity prices to increase. Since poorer households have lower expenditure than richer households, these households will have a larger percentage of their basket devoted to the necessity good. This increase in necessity prices will increase the low-income households price index relative to high-income households.

It has been documented that both recessions (Heathcote et al. 2020) and contractionary monetary policy (Coibion, Gorodnichenko, Kueng, Silvia 2018) increase inequality. Since demand for the necessity good depends on both aggregate expenditure (decreasing) and inequality (decreasing), a shock that simultaneously lowers aggregate expenditure and raises inequality would have ambiguous effects on relative necessity demand. To fix ideas, if representative expenditure  $x^r$  is a function  $F(\cdot)$  of aggregate expenditure  $\bar{x}$  and expenditure

inequality  $\Sigma_x$  then the elasticity of representative expenditure to a macroeconomic shock,  $\mathcal{E}_{x^r, shock}$ , would be:

$$\mathcal{E}_{x^r, shock} = \mathcal{E}_{x^r, \bar{x}} \mathcal{E}_{\bar{x}, shock} + \mathcal{E}_{x^r, \Sigma_x} \mathcal{E}_{\Sigma_x, shock}. \quad (\text{A.6})$$

In equation (A.6), the elasticity of representative expenditure to a shock depends on both the elasticity of aggregate expenditure to the shock and the elasticity of inequality to the shock, where each term is scaled by the elasticity of representative expenditure to either aggregate expenditure or inequality.<sup>35</sup> In the empirical section, I show that following a monetary policy shock the effect coming through aggregate expenditure dominates.

### A.3 Derivation of Wage-Phillips Curve

I add sticky wages by following the convention in the literature and creating market power in the labor market via a labor union (see Erceg et. al. 2000, Auclert et. al. 2018, Auclert et. al. 2020, Broer et. al. 2020, Ramey 2020).

Specifically, each worker (i) in the economy provides  $h_{ikt}$  hours of labor to each of a continuum of unions indexed by  $k \in (0, 1)$ . Total labor for person (i) is then:

$$h_{it} = \int_k h_{ikt} dk. \quad (\text{A.7})$$

Each union  $k$  aggregates units of work into a union specific task  $H_{kt} = \int_i h_{ikt} di$ .

There is a competitive labor packer that takes labor from unions and packages it into one unit of “usable” labor following a CES function. Aggregate labor is then:

$$H_t = \left( \int_k H_{kt}^{\frac{\epsilon_w - 1}{\epsilon_w}} \right)^{\epsilon_w / (\epsilon_w - 1)}, \quad (\text{A.8})$$

---

<sup>35</sup>In the PIG-Log (AIDS) specification I adopt in the main text, the elasticity of  $x^r$  with respect to both aggregate expenditure and inequality (as measured by the Theil index) is one, so equation (A.6) reduces to just  $\mathcal{E}_{\bar{x}, shock} + \mathcal{E}_{\Sigma_x, shock}$ . Coibion et al. (2017) finds that the elasticity of the standard deviation of expenditure increases by .03 four months after a one-standard deviation monetary policy shock, while consumption falls by approximately 0.5 percent. Given that the Theil coefficient for a log-normal distribution is  $\sigma^2/2$  it follows that the aggregate expenditure elasticity dominates the inequality elasticity.

where  $\epsilon_w$  is the elasticity of substitution between different types of labor.

Unions set a common wage  $w_{kt}$  for all members and require each member household to supply uniform hours:  $h_{ikt} = H_{kt}$ .

Following (Auclert et al. 2018,2020) I add an extra disutility term for households, so that households dislike adjusting wages:

$$\frac{\psi_w}{2} \int_k \left( \frac{w_{kt}}{w_{kt-1}} - 1 \right)^2 dk, \quad (\text{A.9})$$

where  $\psi_w$  scales the degree of wage stickiness.

At time  $t$ , union  $k$  sets wage  $w_{kt}$  to maximize (on behalf of all union workers):

$$\begin{aligned} \max_{w_{kt}} \mathbb{E}_t \sum_{\tau > 0} \beta^{t+\tau} & \left( \int [V(X_{it+\tau}, \mathbf{p}_{t+\tau}) - g(h_{i,t+\tau})] d\psi_{it+\tau} - \frac{\psi_w}{2} \int_k \left( \frac{w_{kt}}{w_{kt-1}} - 1 \right)^2 dk \right) \\ \text{s.t. } H_{kt} &= \left( \frac{w_{kt}}{W_t} \right)^{-\epsilon_w} H_t \end{aligned} \quad (\text{A.10})$$

The union takes as given the distribution  $\psi_{it}$  of workers (in this version of the model, all workers are identical) and all prices excluding  $w_{kt}$  (note that  $W_t = (\int_k w_{kt}^{1-\epsilon_w} dk)^{1/(1-\epsilon_w)}$ .)

The envelope theorem allows me to ignore both the intertemporal reoptimization of saving or spending in response to a marginal change in wages, along with the intratemporal reoptimization of spending across sectors. I treat any change in income as a change in consumption expenditure:

$$\begin{aligned} \frac{\partial X_{it}}{\partial w_{kt}} &= \frac{\partial}{\partial w_{kt}} \int_0^1 w_{kt} h_{ikt} dk \\ &= \int_0^1 \frac{\partial}{\partial w_{kt}} w_{kt} \left( \frac{w_{kt}}{W_t} \right)^{-\epsilon_w} H_t dk \\ &= (1 - \epsilon_w) \left( \frac{w_{kt}}{W_t} \right)^{-\epsilon_w}. \end{aligned}$$

I next derive the change in hours worked to a change in wages for household (i) using the labor rule that  $H_{kt} = h_{ikt} \forall i$  and the demand constraint:

$$\begin{aligned}\frac{\partial h_{it}}{\partial w_{kt}} &= -\epsilon_w \left( \frac{w_{kt}^{-\epsilon_w-1}}{W_t^{-\epsilon_w}} \right) \\ &= -\epsilon_w \frac{H_{kt}}{w_{kt}}.\end{aligned}$$

It follows that the first order condition of the union's maximization problem equation (A.10) becomes:

$$\begin{aligned}\int H_{kt} \left[ V_X(X_i t, \mathbf{p}_t) (1 - \epsilon_w) \left( \frac{w_{kt}}{W_t} \right)^{-\epsilon_w} + \frac{\epsilon_w}{w_{kt}} g'(h_{it}) \right] d\psi_{it} - \psi_w \left( \frac{w_{kt}}{w_{kt-1}} - 1 \right) \frac{1}{w_{kt-1}} \\ + \beta \psi_w \mathbb{E}_t \left[ \left( \frac{w_{k,t+1}}{w_{k,t}} - 1 \right) \left( \frac{w_{k,t+1}}{w_{k,t}^2} \right) \right] = 0.\end{aligned}$$

This simplifies when we note that the maximization problem for all unions is identical, so in equilibrium  $w_{kt} = w_t$ . Denoting  $\pi_t^w \equiv \left( \frac{w_t}{w_{t-1}} - 1 \right)$  and using the functional forms for  $V[\cdot]$  and  $g(\cdot)$  provided in section 6 yields:

$$\begin{aligned}\psi_w \pi_t^w (1 + \pi_t^w) = & \beta \mathbb{E}_t \left( \psi_w \pi_{t+1}^w (1 + \pi_{t+1}^w) \right) + \\ & H_t w_t \int \left[ \frac{1}{a(\mathbf{p}_t) b(\mathbf{p}_t)} \left( \frac{X_t}{a(\mathbf{p}_t)} \right)^{((1-\eta)/b(\mathbf{p}_t))-1} (1 - \epsilon_w) + \frac{\epsilon_w}{W_t} \varphi H_{it}^\phi \right] d\psi_{it}.\end{aligned}$$

In the representative agent model that I am considering here, this further simplifies to:

$$\begin{aligned}(1 + \pi_t^w) \pi_t^w = & \beta \mathbb{E}_t \left[ (1 + \pi_{t+1}^w) \pi_{t+1}^w \right] \\ & + \left( \frac{\epsilon_w}{\psi_w} \right) \left( \varphi H_t^\phi - \left( \frac{\epsilon_w - 1}{\epsilon_w} \right) \frac{W_t}{a(\mathbf{p}_t) b(\mathbf{p}_t)} \left( \frac{X_t}{a(\mathbf{p}_t)} \right)^{((1-\eta)/b(\mathbf{p}_t))-1} \right) \quad (\text{A.11})\end{aligned}$$

It follows that the union will adjust wages in expectations of future wage inflation or when the marginal disutility of labor is higher than the product of marginal utility of expenditure and the optimal wage.



## B Data Appendix

### B.1 Defining Household Income Groups

I use both the diary and interview survey from the 1980-2022 CEX waves. I divide households into five different income groups similar to Aguiar and Bils (2015) (the main deviation is that I use a much longer sample of CEX data). Namely, I keep only households that participate in all four CEX interviews and are complete income reporters. I also include only urban households and households whose household head is between 25 and 64. I divide households into five different income groups based on their pre-tax income. In addition to pre-tax income reported in the CEX, I include income from alimony, gifts, gambling winnings, inheritance, and any other payments from persons outside the household; similarly, I subtract from income the alimony, child support, etc. paid by the household. Since I am using survey data from multiple years, I deflate all household income by the PCE price index. Next, I regress this income measure on dummies of the household size, max age of household head, and the number of income earners in the household.

Then, I organize households into groups based on their real income percentile across the entire sample (1980-2022). Similar to Aguiar and Bils (2015), the top income group is households in the 80th-95th percentile of income (this lessens the degree to which changes in top-coding and outliers can change the composition of the top group). The bottom income group is households in the 5th-20th percentile of income. Groups 2, 3, and 4 are households in the 20th-40th percentile, 40th-60th percentile, and 60th-80th percentile, respectively.

### B.2 PCE Categories

I match PCE sectors with UCC codes from the CEX using the BLS staff's PCE-CE crosswalk (Bureau of Labor Statistics 2019). This crosswalk was designed for the post-1990 CEX survey waves, so I extend the crosswalk to match UCC codes that only exist in the earlier 1980 waves of the CEX.<sup>36</sup>

I exclude rent and owners-equivalent-rent since most high-income households are home-

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<sup>36</sup>This extended crosswalk is available upon request from the author.

owners while low-income households generally rent their homes. While the BLS constructs an imputed owners' equivalent rent series, homeowners do not actually pay this price. When rent prices change, homeowners can still consume at their initial endowment point and are shielded from increases in home prices. While studying the effects of owning versus renting on real income and wealth inequality is an interesting area of research, it is not the focus of this article. I also exclude non-market PCE prices and quantities such as charitable donations, gambling, and meals or rent as pay.

This leaves me with 148 distinct categories for which I have aggregate spending and price data from the NIPA underlying detail tables and income level expenditure information from the diary and interview CEX surveys. The 148 categories represent 73 percent of December 2019 total PCE.

### **B.3 Expenditure Shares**

I create income group expenditure shares as the household survey weighted average of household expenditure shares for all households in the income group (democratic weighting). Note that this procedure is different from how the BLS creates expenditure shares for the CPI, since they also base their shares on the contribution of the household to total spending, which puts more weight on higher spending households. Since this paper is focused on non-homotheticities in consumption shares, weighting based on expenditure is problematic, as it would give more weight to households at the upper end of an income group (say those nearer to the 20th percentile versus those nearer the 5th percentile). This weighting could also be a problem when some households report more of their expenditure than others (see Aguiar and Bils (2015) for under-reporting in the CEX).

I start by creating average sector-level income group expenditure shares separately in the interview and diary survey. To maintain democratic weighting, when categories in the diary and interview survey represent both the same type and aggregation level of spending (such as for some clothing categories) I use the expenditure share for the interview survey since the interview survey is representative of the household's complete expenditure basket. For categories that overlap but that are at a finer level of aggregation in the diary survey (for example subcategories of food at home) I multiply the expenditure weight of the larger

interview category  $J$  by the diary subcategory share of spending on sector  $J$ :

$$s_{ji} = s_{Ji} \times \frac{x_{ji}}{\sum_{k \in J} x_{ki}} j \in J. \quad (\text{B.1})$$

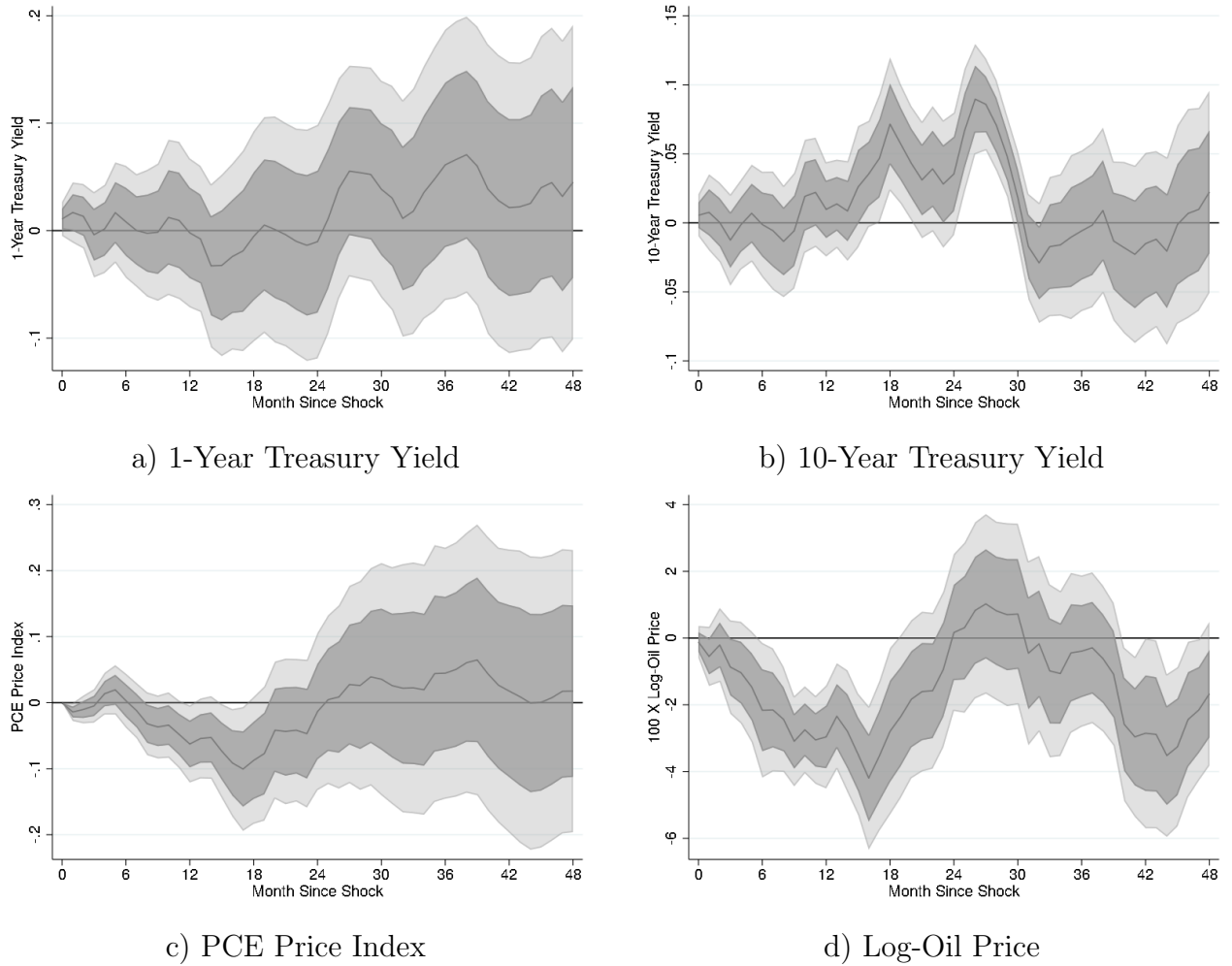
As an example, for subcategories of food at home, I create the expenditure share by multiplying each subcategories share of food at home spending from the diary survey by the share of food at home in total spending from the interview survey.

## B.4 Time Series Local Projection Results

Figures A1 shows additional time series results of responses to the Bauer and Swanson (2022b) monetary shock. Panel a) shows that following the monetary policy shock the 1-year treasury yield increases, however, the increase is not statistically significant. In contrast, the 10-year treasury yield, shown in panel b) increases following the shock and reaches a peak of around 7.5 basis points between 18- and 30- months after the monetary policy news surprise. Panel c) shows that the PCE price index declines starting a bit after 6-months after the shock and reaches a trough of around 0.1 percentage points lower 18 months after the shock. Finally, the oil price initially declines following the shock before rising back to baseline and then falling again.

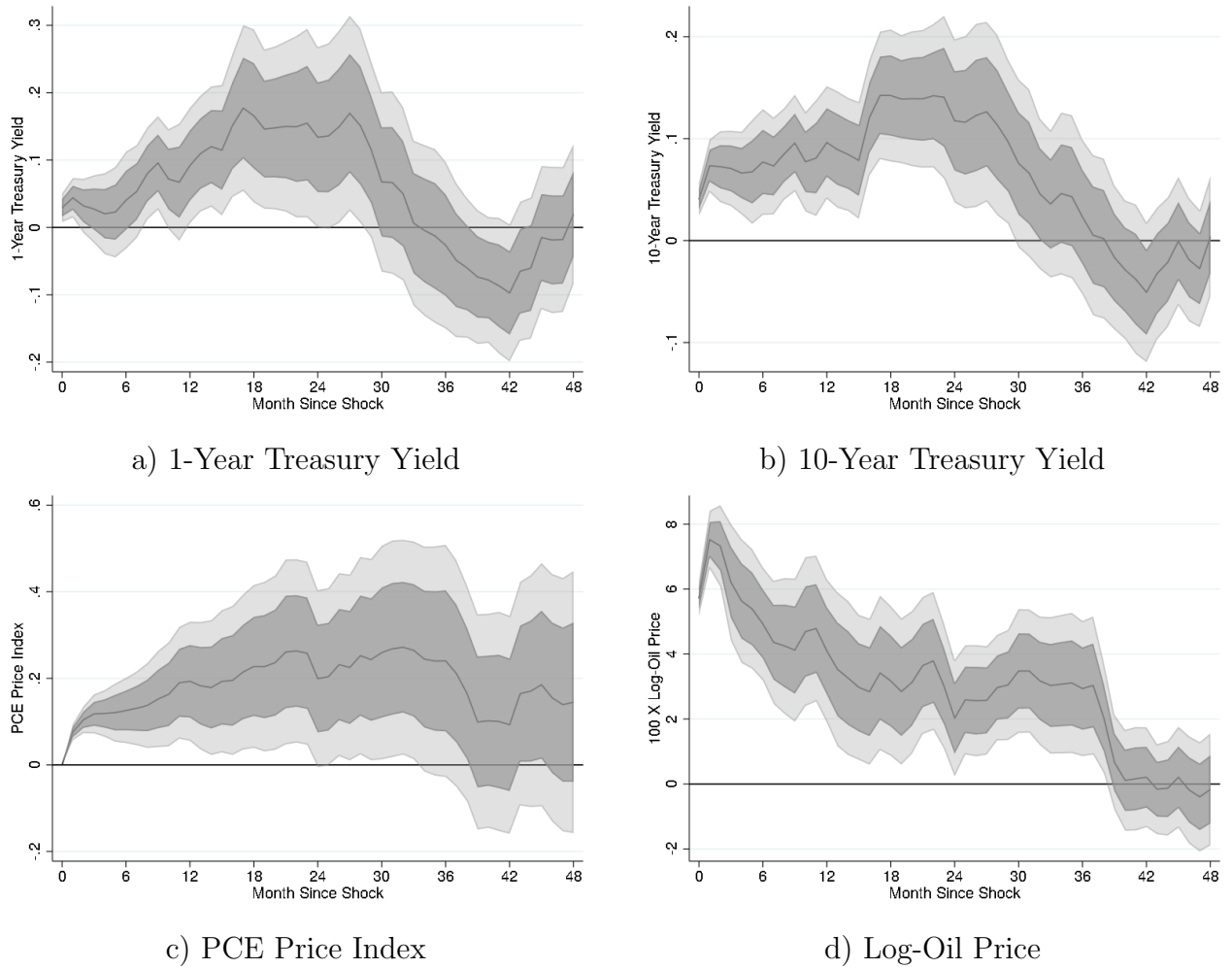
Figure A2 shows additional time series results of the response of interest rates, the PCE price index, and the oil price to a Känzig (2021) oil shock. The oil shock leads to a statistically significant increase in both the 1- and 10-year treasury yields, as shown in panels a) and b). The oil shock also leads to a persistent increase in the overall PCE price index of around 0.2 percentage points. Finally, the oil price increases by around 7 percent 3-months after the shock before receding to between 3 and 4 percent 12 to 36 months after the shock. The oil price mean reverts after 40-months.

**Figure A1: Response to Monetary Policy Shock**



Note: Data from 1989-2019. Estimated coefficients, from Local Projections represent the response of the dependent variable to a one-standard deviation Bauer and Swanson (2022b) monetary shock. The unit of observation is the month. The dark and light shaded areas represent 90 and 68 percent confidence bands respectively. Standard errors are robust to auto-correlation.

**Figure A2: Response to Oil Price Shock**



Note: Data from 1976-2023. Estimated coefficients, from Local Projections represent the response of the dependent variable to a one-standard deviation Känzig (2021) oil shocks . The unit of observation is the month. The dark and light shaded areas represent 90 and 68 percent confidence bands respectively. Standard errors are robust to auto-correlation.

## B.5 IRF Robustness Checks

### B.5.1 Monetary Robustness Checks

Here I present several robustness checks that complement my IRF results in the main text. In figure A3, I show results from my baseline monetary model from equation 4.1, but using the monetary high-frequency news shocks from Gertler and Karadi (2015) or Miranda-Agrippino and Ricco (2021). These alternative shocks have been widely cited in the literature. Like the Bauer and Swanson (2022b) shocks, they are based on high frequency movements of Fed-future prices in a small window around FOMC meetings. Unlike the Bauer and Swanson (2022b) shocks, these other shocks do not use information from FED chair speeches, which Swanson and Jayawickrema (2023) argues can be more important for macro variables than regular monetary policy announcements. These other shock series are also a bit shorter than the Bauer and Swanson (2022b) series; the Gertler and Karadi (2015) goes from 1990 to 2012 and the Miranda-Agrippino and Ricco (2021) is from 1991-2009 compared to 1989-2019 for the Bauer and Swanson (2022b) series. The Miranda-Agrippino and Ricco (2021) orthogonalizes the monetary policy surprise by the Federal Reserve Staff’s forecast.

As shown in panel a) the results for necessity shares are mixed. The Gertler and Karadi (2015) shocks result in a much smaller effect on relative necessity shares than in my baseline, while Miranda-Agrippino and Ricco (2021) results in a smaller increase in the relative log-share of around 0.3 percentage points, compared to the around 0.5 percentage points in my baseline specification. Panel b) shows that the results on the log-price are more consistent, with the IR for the two alternative monetary policy shocks mostly within the one-standard deviation confidence interval of my baseline model. However, consistent with these alternative shocks having a smaller impact on necessity shares, the results on necessity prices are somewhat smaller as well.

In figure A6 I show results from several different alternative specifications where  $\Gamma_{h,k}W_{j,t-k}$  is taken to include the interaction between the PCE sectors total oil cost-share and the current and lagged changes in the oil prices (baseline shown as the black solid line), only the oil price change interaction (shown as the green dashed line), empty (shown as the long dashed yellow line), and to include the baseline interactions as well as an interaction between the

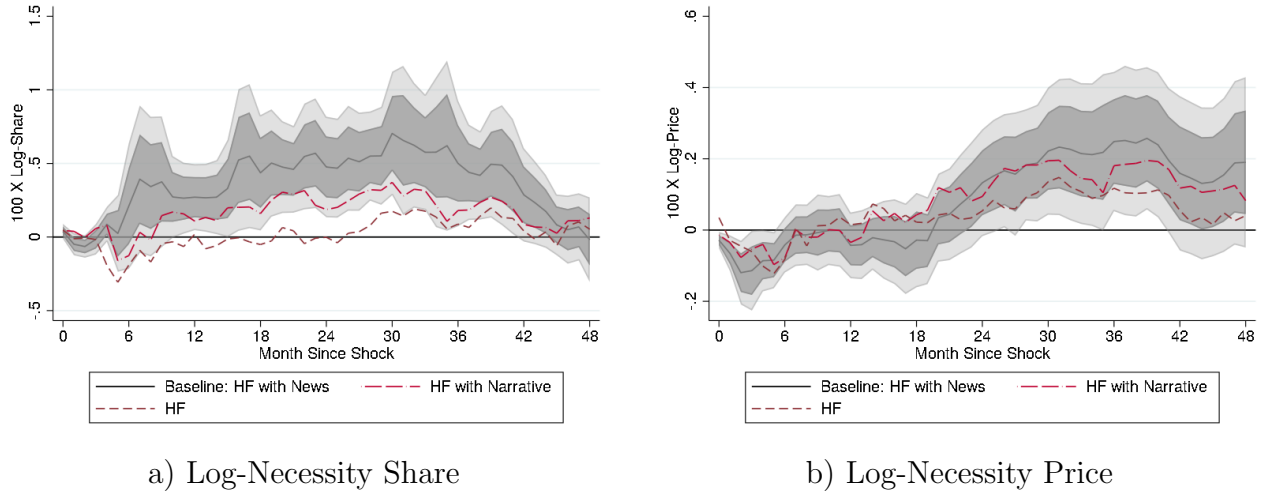
PCE sectors monthly price change frequency and the monetary policy shock (the solid red line). The results for the log-share IRF are very similar between the baseline and the alternative specifications. For the response of the necessity log-price to the monetary policy shock, the baseline results are most similar to the specification that removes the durable interaction. The specification that removes both the durable and oil price interactions leads to a lower increase in the necessity price than in the baseline, although the results are mostly within the 90 percent confidence interval. Finally, in the specification that includes the price change frequency interaction the log-price responds more than in the baseline for the first 24 months, and less from months 24-48, with the results mostly within the baseline 90 percent confidence interval.

In figure figure A5, I redo the IRFs and robustness tests, but the main coefficient of interest is now the interaction between a binary definition of necessity and the monetary policy shock, rather than the continuous expenditure ratio measure that I use in the main text. The estimated coefficients are quite similar to the results in the main text: a one-standard deviation monetary policy shock leads to a 0.5 percent increase in relative necessity shares and a 0.2 percent increase in relative necessity prices, quite similar to the results in the main text. This implies a necessity relative price elasticity of expenditure of around  $-1$ .

Finally, figure figure A7 computes IRFs of real-sectoral expenditure to a monetary policy shock. This set of results show that relative real demand for necessities rise following a monetary policy shock and the results for the log-share that I find in the main text are not simply mechanically driven due-to higher necessity prices.

### **B.5.2 Oil Price Shock Robustness Checks**

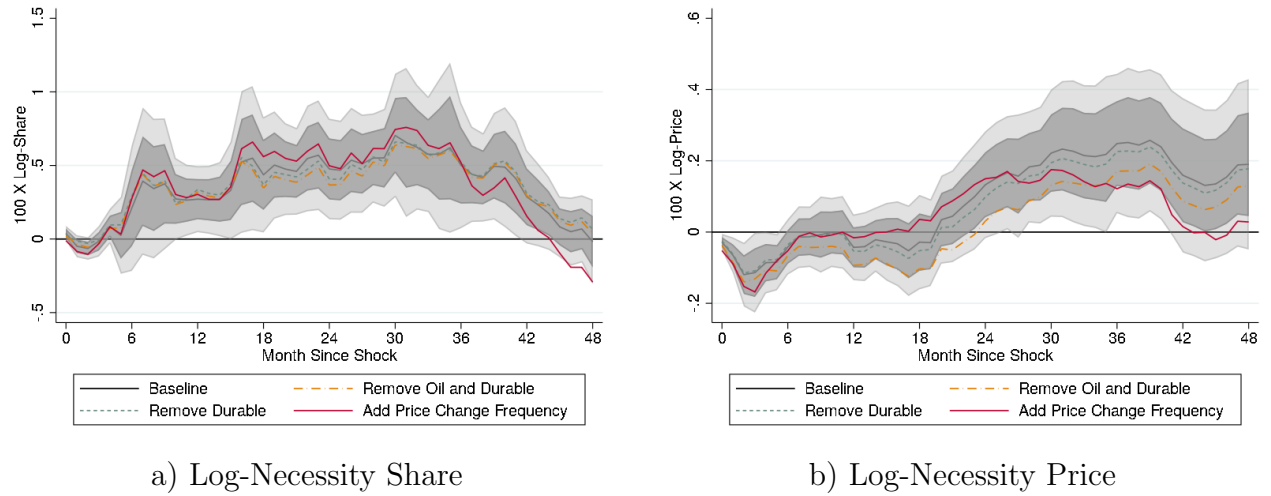
**Figure A3:** Necessity Response to Alternate Monetary Policy Shock



Note: Estimated coefficients,  $\gamma^{h,0}$  from Local Projections in equation (4.1) represent the response of the dependent variable to a one-standard deviation monetary contraction using the Bauer and Swanson (2022b), Gertler and Karadi (2015), or Miranda-Agrippino and Ricco (2021) monetary shocks interacted with  $R_j$ . The unit of observation is the PCE sector-month. The dark and light shaded areas represent 90 and 68 percent confidence bands respectively for the Bauer and Swanson (2022b) shock. Standard errors are robust to auto-correlation and are clustered at the monthly level. PCE sectors weighted by their share in pooled aggregate expenditure. Monetary Policy shock normalized to be mean zero and standard deviation of one.

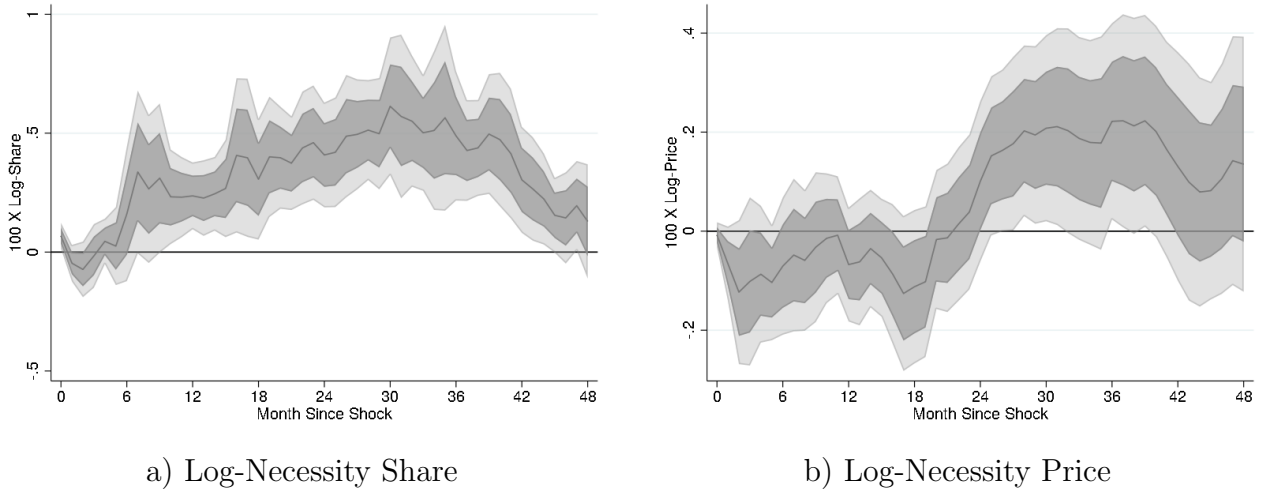


**Figure A4:** Necessity Response to a Monetary Policy Shock: Alternate Specifications



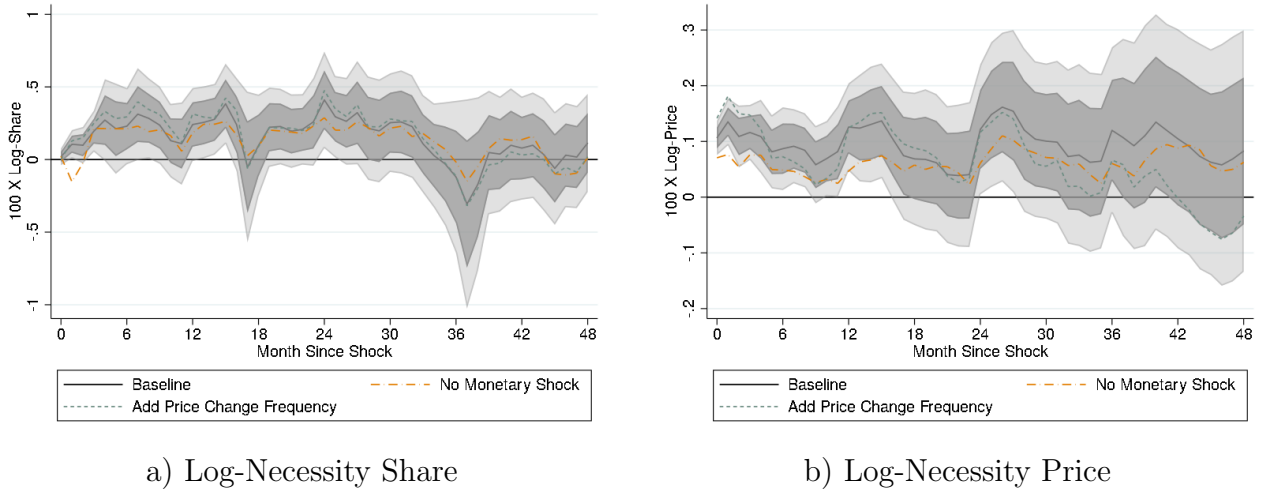
Note: Data from 1989-2019. Estimated coefficients,  $\gamma^h$  from Local Projections in equation (4.1) represent the response of the dependent variable to a one-standard deviation monetary contraction using the Bauer and Swanson (2022b) monetary shocks interacted with  $R_j$ . The unit of observation is the PCE sector-month. The dark and light shaded areas represent 90 and 68 percent confidence bands respectively for the baseline specification. Standard errors are robust to auto-correlation and are clustered at the monthly level. PCE sectors weighted by their share in pooled aggregate expenditure. Monetary Policy shock normalized to be mean zero and standard deviation of one.

**Figure A5:** Binary Definition of Necessity Response to Monetary Policy Shock



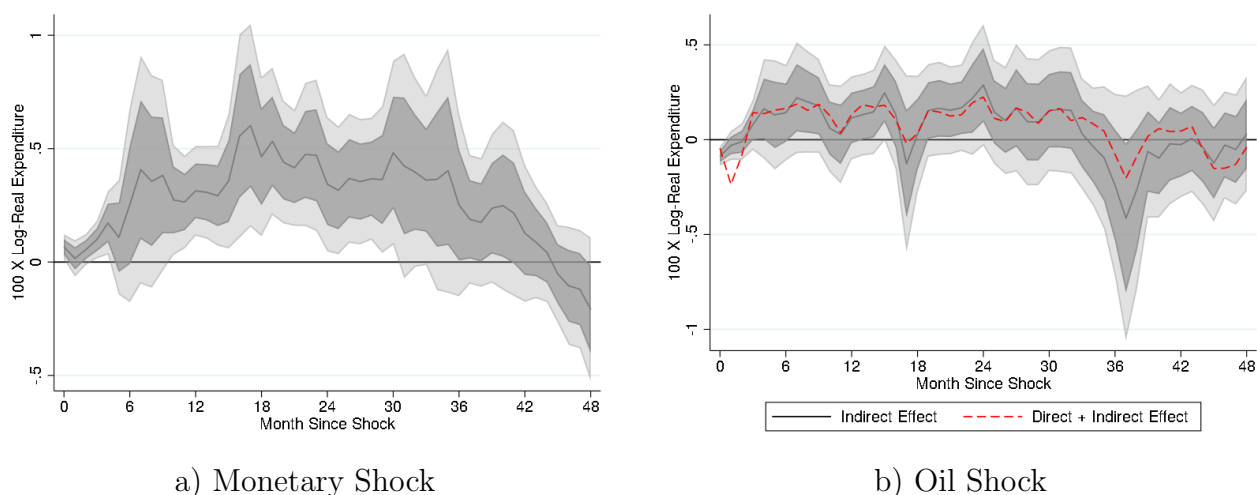
Note: Data from 1989-2019. Estimated coefficients,  $\gamma^{h,0}$  from Local Projections in equation (4.1) represent the response of the dependent variable to a one-standard deviation monetary contraction using the Bauer and Swanson (2022b) monetary shocks interacted with  $1\{R_j > 1\}$ . The unit of observation is the PCE sector-month. The dark and light shaded areas represent 90 and 68 percent confidence bands respectively. Standard errors are robust to auto-correlation and are clustered at the monthly level. PCE sectors weighted by their share in pooled aggregate expenditure. Monetary Policy shock normalized to be mean zero and standard deviation of one.

**Figure A6:** Necessity Response to an Indirect Oil Shock: Alternate Specifications



Note: Data from 1989-2019. Estimated coefficients,  $\gamma^h$  from Local Projections in equation (4.1) represent the response of the dependent variable to a one-standard deviation monetary contraction using the Bauer and Swanson (2022b) monetary shocks interacted with  $R_j$ . The unit of observation is the PCE sector-month. The dark and light shaded areas represent 90 and 68 percent confidence bands respectively for the baseline specification. Standard errors are robust to auto-correlation and are clustered at the monthly level. PCE sectors weighted by their share in pooled aggregate expenditure. Monetary Policy shock normalized to be mean zero and standard deviation of one.

**Figure A7:** Panel Local-Projection: Necessity Real Expenditure Response to Monetary and Oil Shocks



Note: Data from 1989-2019 in panel a) and 1976-2023 in panel b). Estimated coefficients,  $\gamma^h$  from Local Projections in equation (4.1) represent the response of log-expenditure deflated by the sector specific price index to a one-standard deviation Bauer and Swanson (2022b) monetary shock or Känzig (2021) oil shock interacted with  $R_j$ . The unit of observation is the PCE sector-month. The dark and light shaded areas represent 90 and 68 percent confidence bands respectively. Standard errors are robust to auto-correlation and are clustered at the monthly level. PCE sectors weighted by their share in pooled aggregate expenditure.

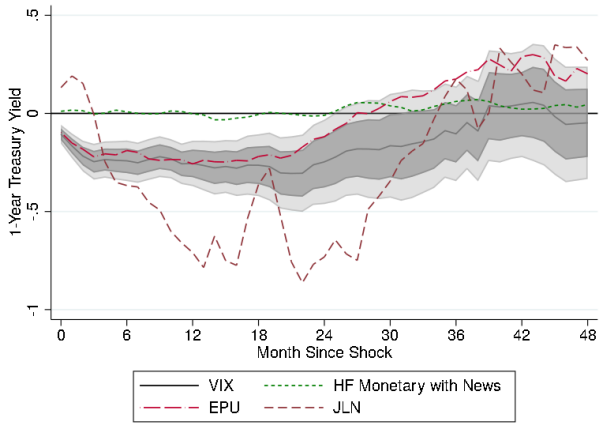
## B.6 Uncertainty Shock

I estimate the response of treasury yields, expenditure, relative necessity prices and shares to several different types of uncertainty shocks. The first is the VIX index, which has been widely used in the literature ordered first in a VAR, which assumes that the VIX can contemporaneously impact other macroeconomic variables, but not the other way around (see Leduc and Liu (2016) and Basu and Bundick (2017); my local projection specification makes the same assumption. I also use the Economic Policy Uncertainty (EPU) index developed by Baker et al. (2016), which uses newspaper articles to measure uncertainty about future US economic policy including congressional outcomes, presidential elections, and Federal Reserve Policy. Finally, I also use the Jurado et al. (2015) (JLN) 1-month ahead econometric uncertainty shocks.

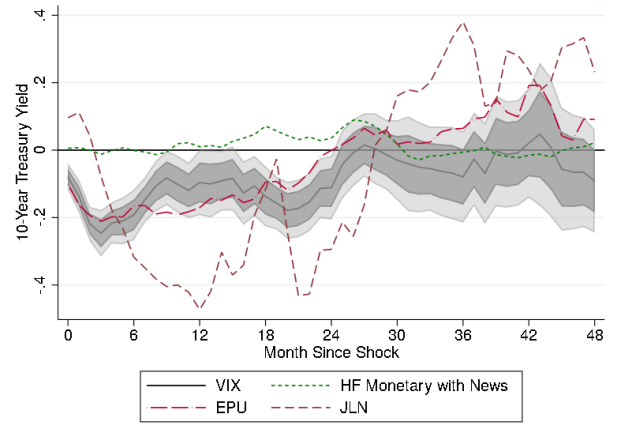
Figure A8 shows the effect that these uncertainty shocks have on treasury yields, and aggregate consumption. Panel a) and b) shows that each of the uncertainty shocks considered lead to large and persistent declines to treasury yields, which is the opposite sign of the effect of monetary policy shocks on yields (the baseline monetary policy shock is shown as the green dashed line). Panel c) shows that each of these shocks also lead to large falls in real PCE. Compared to the monetary policy shock, the uncertainty shocks have a more immediate and larger effect on consumption. The JLN shocks have by far the largest effect on real PCE, and a one-standard deviation JLN shock leads to around a 2 percent decline in real PCE that peaks 18- to 24-months after the shock, while the VIX and EPU shocks lead to a 0.5 and a 0.3 percent decline in real-PCE respectively on average in the first 12-months after the shock.

Figure A9 estimates the relative necessity share and price response to uncertainty shocks using the baseline specification in 4.1, but replacing the monetary policy shock with uncertainty shocks. I find large impacts on necessity shares and prices. Panel a) shows that following the shock, the necessity share increases by approximately 0.4 percent after the EPU shock, 0.6 percent after the VIX shock, and 2.4 percent after the JLN shock (averaging horizons 12-36). The baseline monetary policy shock effect on relative necessity prices lies between the EPU and VIX shocks and is dwarfed by the response to the JLN shock.

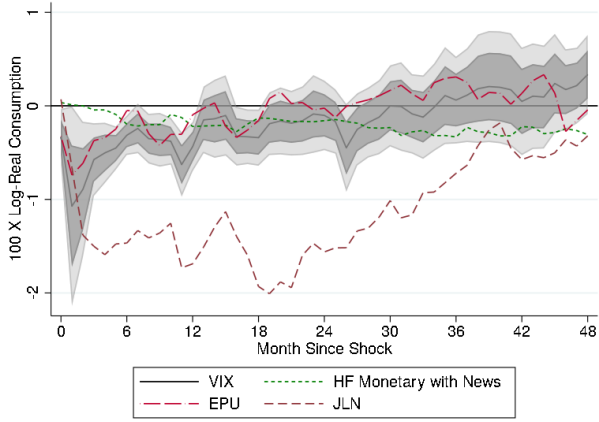
**Figure A8: Response to Uncertainty Shock**



a) 1-Year Treasury Yield



b) 10-Year Treasury Yield



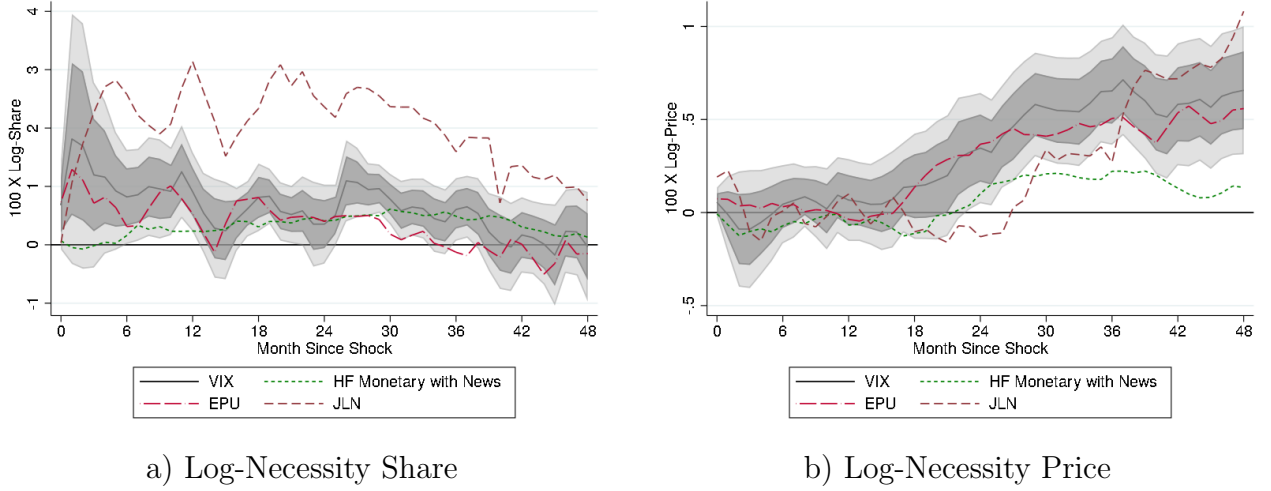
c) Real PCE

Note: Data from: 1989-2019 (Monetary Policy Shock), 1990-2024 (VIX), 1985-2024 (EPU), and 1960-2023 (JL). Estimated coefficients, from Local Projections represent the response of the dependent variable to a one-standard deviation uncertainty or monetary shock. The unit of observation is the month. The dark and light shaded areas represent 90 and 68 percent confidence bands respectively for the VIX shock. Standard errors are robust to auto-correlation.

Panel b) shows the effect on necessity prices. Necessity relative prices begin increasing roughly 18-months after the EPU and VIX shocks, which leads the response to the monetary policy shock by about 6 months. The relative necessity price response to the EPU and VIX shocks peak 2 to 3 years after the initial shock at over 0.5 percent (for the VIX) and at over 0.4 percent (for the EPU). The JLN shocks effect on relative necessity prices lags behind the other uncertainty and monetary policy shocks, but ultimately surpasses them peaking

at nearly one percent. This implies that the necessity relative price expenditure elasticity is around  $-1$  for the VIX shock, slightly below  $-1$  for the EPU shock and around  $-0.5$  for the JLN shock.

**Figure A9:** Necessity Response to Uncertainty Shock



Note: Data from: 1989-2019 (Monetary Policy Shock), 1990-2024 (VIX), 1985-2024 (EPU), and 1960-2023 (JL). Estimated coefficients,  $\gamma^{h,0}$  from Local Projections in equation (4.1) represent the response of the dependent variable to a one-standard deviation uncertainty or monetary shocks interacted with  $R_j$ . The unit of observation is the PCE sector-month. The dark and light shaded areas represent 90 and 68 percent confidence bands respectively for the VIX shock. Standard errors are robust to auto-correlation and are clustered at the monthly level. PCE sectors weighted by their share in pooled aggregate expenditure. Monetary Policy shock normalized to be mean zero and standard deviation of one.

## C Alternate Calibrations

As mentioned in the main text, I consider several alternative calibrations. I consider three different values for  $\alpha$ ; (1)  $\alpha = 0.366$  from Fernald (2014), (2)  $\alpha = 0.3$ , which is implied by letting the marginal elasticity of marginal cost to quantity supplied in the model equal the median estimated value in Hottman and Monarch (2020), and (3)  $\alpha = 0.16$ , which is implied by the median results for  $\omega$  in Feenstra and Weinstein (2017). I also directly estimate  $\beta_L$  and  $\gamma_{LN}$  from the micro-data, and use these values. The method of estimation is described in the next subsection.

## C.1 Demand Parameter Estimation

I follow Deaton and Muellbauer (1980) and Fajgelbaum and Khandelwal (2016) when estimating the parameters in the AIDs. Specifically, I estimate equation (5.6) directly from the micro data by replacing  $a(\mathbf{p})$  with a known price index (I use the CPI) so that the coefficient  $\beta_j$  represents changes in the share of expenditure on product  $j$  with changes in real expenditure, so that equation (5.6) becomes:

$$s_j = a_j^* + \sum_k \gamma_{jk} \log(p_k) + \beta_j (x_h^*). \quad (\text{C.1})$$

Where  $x_h^*$  is real household expenditure, and  $a_j^*$  is a transformation of  $a^j$ .<sup>37</sup> Since there are only two sectors, I can estimate equation (C.1) directly via OLS by treating the price of one sector (necessities) as the numeraire and following the parameter restrictions defined earlier:  $\sum_{j=1}^N a_j = 1$ ,  $\sum_{j=1}^N \beta_j = \sum_{j=1}^N \gamma_{jk} = 0$  and  $\gamma_{ij} = \gamma_{ji} \forall i, j$ . Similar to the rest of the analysis, I control for household size, age of the household head, and the number of wage earners. I use the full household sample (1991-2019) and define the necessity good as the composite good of products with relative expenditure ratio greater than one.

Results from this estimation are shown in table A.1. Column one reports the OLS results. I estimate that  $\beta^N = -0.18$ , which implies a luxury sector expenditure elasticity for the representative household of 1.4. I also estimate a positive cross-price elasticity, implying that necessities and luxuries are gross-complements. Column 2 shows an alternate estimation using household log-income and income quintiles as instruments for expenditure ( Aguiar and Bils (2015) estimate expenditure elasticities using income as an instrument to correct for large under-reporting in the CEX).

## C.2 Results

Here I show similar figures as those in the main text, but the the alternate 6 calibrations alongside the baseline calibration.

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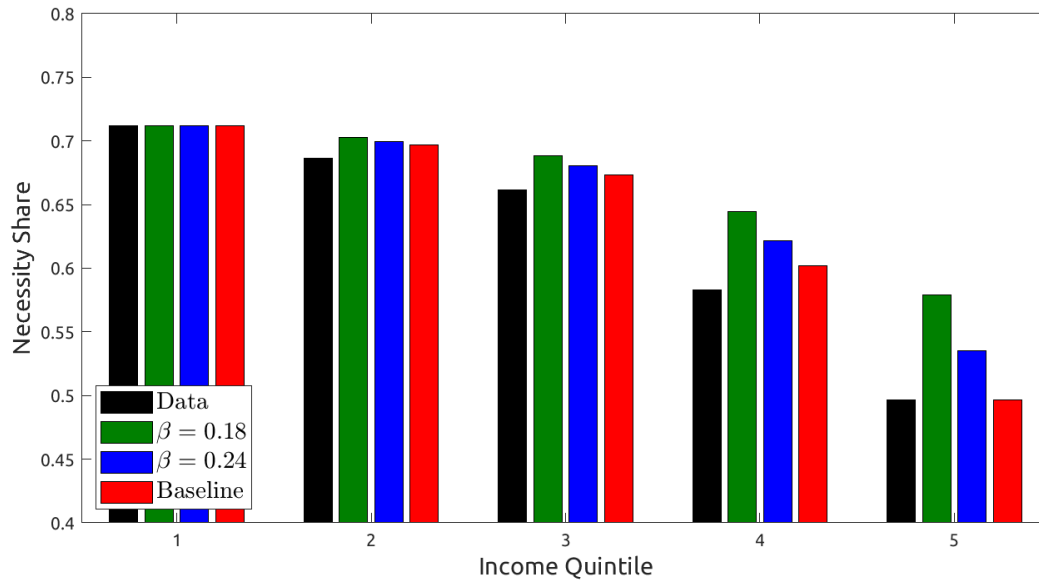
<sup>37</sup>In this framework, the  $a^j$  cannot be separately identified.



**Table A.1:** Almost Ideal Demand System Parameter Estimation

	OLS	IV – Income
	$s_{n,t}^h$ (1)	$s_{n,t}^h$ (2)
Parameter Estimates:		
$\gamma_{NL}$	$9.5 \times 10^{-6}$ (.17) $\times 10^{-6}$	$1.1 \times 10^{-5}$ (0.18) $\times 10^{-5}$
$\beta^N$	-.18 (0.00075)	-.24 (0.0013)
Luxury Expenditure Elasticity	1.39	1.52
Necessity Expenditure Elasticity	.66	.55
Luxury Own Price Elasticity	-1.86	-2.45
Necessity Own Price Elasticity	-1.41	-1.8
Luxury Cross-Price Elasticity	-.86	-1.45
Necessity Cross-Price Elasticity	-.41	-.8
Observations	273,545	273,537

Notes: The unit of observation is the household-quarter. Robust standard errors in parentheses.

**Figure A10:** Model and Data: Necessity Shares by Income Group

Note: Data from 2005-06. Model income-group shares at steady state. The baseline calibration is described in the main text.

Figure A11: Model v. Data: Necessity Shares and Prices

