Proposal: "**Price-Setting, Expectations and Tariffs"**

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With the hereby-suggested contribution to the conference, we propose to shed new light on a longstanding central question in macroeconomics: Do firms' actual price changes react not only to cost realizations, but also the expectations of future costs, and if so, to what extent? Despite this being a central feature in many models of price setting and ultimately, of importance for determining the course of inflation dynamics and the extent of monetary non-neutrality, this question has remained mainly empirically unresolved to this day, especially when using firm-level micro data. The reason lies in the classic identification problem inherent to estimating such equations (see for example Gali et al. (2005) or more recently, using micro data, Boneva et al. (2020)).

Our analysis proposes to make progress in estimating this equation by exploiting firm-level variation in costs and expected costs induced by the recent unexpected tariff shocks, which we assume is exogenous to individual firms and heterogeneous across firms due to differential trade exposure. The analysis will be based on a novel firm level dataset collected in collaboration with the Federal Reserve Bank of Boston and survey company Morning Consult, with two quarters of data for N=500 small and medium businesses each quarter. The first wave will be collected in August 2025, the second in November 2025. Central to our approach is eliciting firm-level current cost changes for the main product or service since the last price adjustment, expected cost changes over the next 12 months and the last price change for the main product or service for a typical customer. Crucially for identification, we will also elicit the (expected) cost changes *conditional* on trade policy changes. This exogenous, firm-specific variation in costs will then allow us to regress as our main specification the following:

$$\Delta P_{it} = \beta_1 \Delta C_{it} + \beta_2 \mathrm{E_{it}}[\Delta \mathrm{C_{it+1}}] + \epsilon_{\mathrm{it}}$$

where ΔP_{it} denote firm i's price at time t, ΔC_{it} their cost change since the last price adjustment *conditional* on trade policy changes, and $\mathrm{E_{it}\Delta C_{it+1}}$ the expected cost change 12 months ahead, also *conditional* on trade policy changes.

To complement our analysis, we will further include and saturate the regression with controls that may be relevant for understanding price setting in the context of the recent, 2025 trade policy changes. We will thus collect information on the political affiliation of the business owners, expected durations of tariffs, and the actual average tariffs paid by firms.

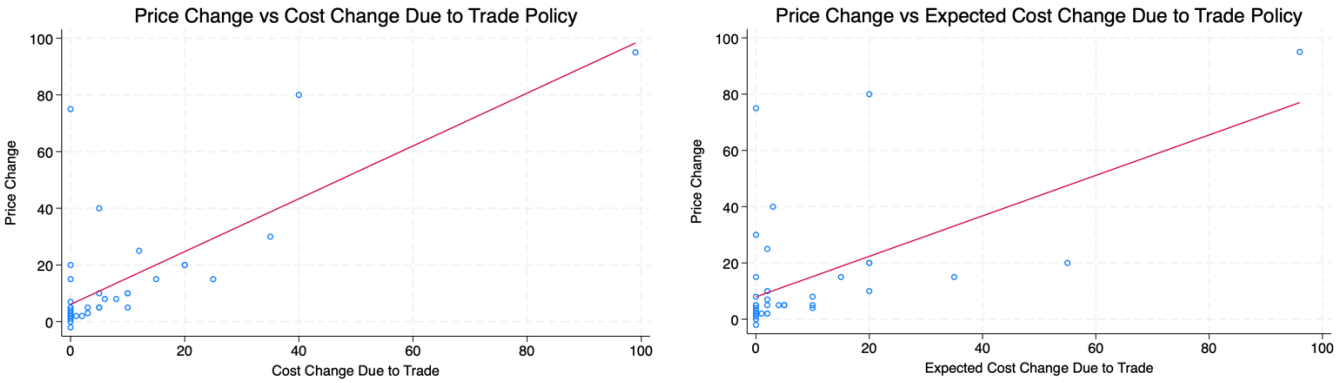


Figure 1: Firm-level price changes, and realized cost changes and expected cost changes conditional on trade policy

Based on a pilot survey of N=40 U.S. small and medium businesses, preliminary results indicate a nuanced view on the role of costs and cost expectations affecting price setting. As Figure 1 above indicates, both cost changes due to trade and expected cost changes due to trade appear to have a significant, causal relationship with price adjustments. The slopes in the first case is approximately 0.9 while 0.7 in the second. However, when both are included into a regression, significance loads only on the first term, realized costs: Preliminary results indicate a highly statistically significant pass-through estimate of 0.9 for cost changes since the last price adjustment, but a similarly precisely estimated zero coefficient on the expectations term. Table 1 shows these findings.

Table 1: Price Changes and (Expected) Cost Changes

	(1)	(2)
Expected Cost Change	0.6683*** (0.000)	−0.0038 (0.984)
Cost Change	—	0.9000*** (0.000)
Constant	5.4343** (0.012)	4.1056** (0.020)
R-squared	0.3480	0.5865
N	40	40

Notes: Coefficients shown with significance stars. Significance levels are based on conventional thresholds (*** p < 0.01; ** p < 0.05; * p < 0.10). P-values in parentheses.

Does this mean that expectations do not matter for price setting? Obviously not. One explanation for the preliminary finding might be that "expectations already happened" – no more relevant earth-shattering cost changes due to trade policy will happen and have been captured in current costs already. Contrary to that, firms still indicate non-zero cost change expectations ruling out this explanation, at least in theory. Another possibility is that perhaps the current policy environment and tariff changes are quite special. For instance, the high uncertainty surrounding where tariff rates will settle could lead firms to place less stock in their cost expectations. Though our pilot survey did not capture uncertainty, we plan to examine this possible determinant of the degree of forward-looking behavior in price-setting in our full survey.

We do not purport to present which model of taking these changes into account might be optimal for firms but hope that the results of the analysis will provide empirical regularities with which to discipline such modeling efforts.

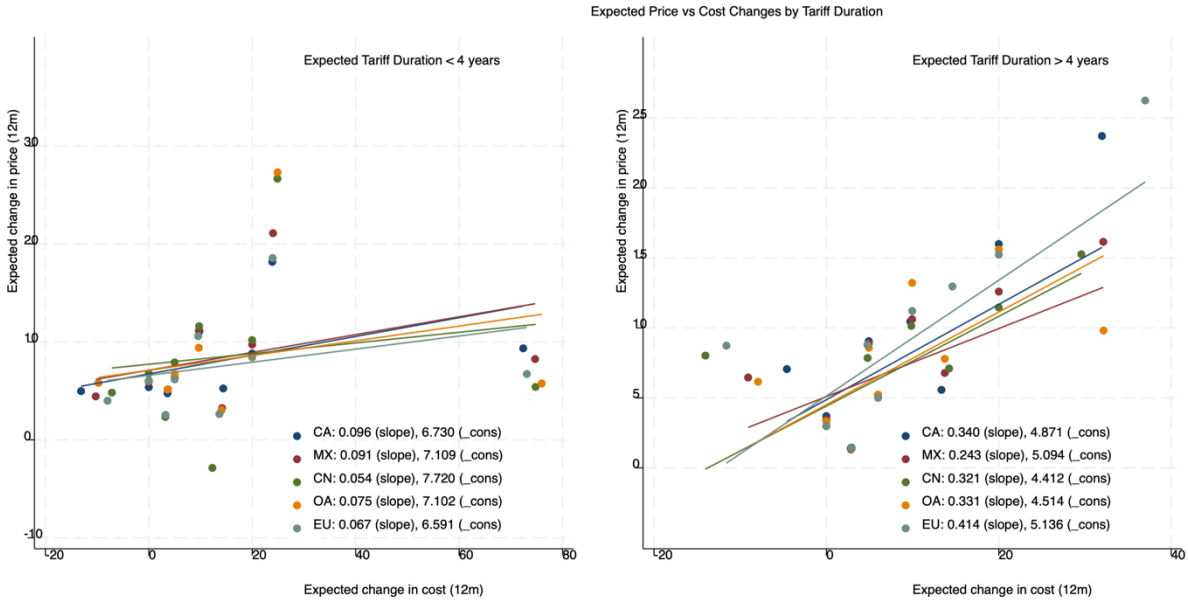


Figure 2: Expected price and expected cost changes, by expected tariff duration and source country

Further to that effect, we also propose to exploit our rich control variables from the survey, in particular on political affiliation and expected tariff duration. We aim to answer, within a sufficiently large sample, questions such as whether political affiliation of small and medium business owners is related to the extent of passthrough of cost change expectations in their price setting process. Also, we propose testing if political horizons and beliefs reflected in the expected duration of tariffs will affect price setting and (expected) cost-price passthrough. Indicative of such more nuanced effects of expectations is preliminary evidence from another survey wave shown below: Here, firms who believe that tariffs will remain in place for more than 4 years, exhibit 3 times larger pass-through of expected costs into expected prices.

Conclusion:

This project will use a survey of small and medium-sized businesses in combination with the unfolding trade policy shock to shed light on the degree of forward-looking behavior in firms' actual pricing decisions, a foundational feature of many price-setting theories that still remains empirically unresolved. Preliminary results from a pilot survey suggest that, in response to

exogenous trade cost shocks, firms are changing prices based on already-experienced cost changes and not responding to *expected* cost changes. Further analysis will shed light on potential determinants of this behavior including uncertainty and the expected persistence of the shock.

References

Boneva, Lena, James Cloyne, Martin Weale, and Tomasz Wieladek (2020). “Firms’ price, cost and activity expectations: evidence from micro data”. The Economic Journal 130 (627), 555–586.

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