



July 18, 2022

Wage and Price Control: A bad good idea?

By Stéfane Marion and Paul-André Pinsonnault

The history of price control can be dated back 4000 years, to the Code of Hammurabi, which among other provisions included laws governing business contracts and appropriate prices for goods. Fast forward to the U.S. 400 years ago, when Massachusetts and Virginia did likewise. More recently, many countries have experimented at one point or another in the 20th century, in war and in peace, with wage and price controls (WPC). So such controls have had a very long history.

Focusing on the last 120 years, we note that in periods of crisis such as the two world wars, price controls have been rather effective as temporary measures to limit inflation. Some have argued that in wartime such measures may rally enough public support and political will to make them stick. In a time of crisis, people will tolerate the inconveniences they bring such as waiting lines or empty shelves. In such times patriotic duty can go far to gather support for government initiatives. In peacetime, critics will come from left, right and centre. Public support for such policies will erode more or less rapidly depending on how stringent the controls are. Unfortunately, history tell us that controls that are less severe accomplish nothing, while quite restrictive ones bring only temporary relief from inflation and risk being abandoned early on, contributing to limitation of their success. In other words, the success of wage and price controls depends largely on their design and the conditions under which they are imposed. Yet experience has shown that although “successful” wage and price controls can influence the time path of inflation, once they are removed inflation will go where it would have been had they never been imposed.

WPC are not a sufficient or even a required condition for achieving price stability. As economists would say: On their own they will not shift inflation to a stable, reasonably low track in the years immediately following decontrol.

That said, one argument in their favour is that they may ease the transition cost (unemployment) of the movement from an environment of high inflation toward one of inflationary expectation anchored at a more sustainable level. A point of view that was apparently shared by the Bank of Canada in 1975. In its annual report that year, the Bank suggested “that price and wage control could be a useful supplement to financial discipline ... [to] bring about the needed adjustment at less cost in terms of unemployment and lost output, and with less serious inequities, than would result from sole reliance on monetary and fiscal policies.”

However, WPC are not cost-free. They come with administrative costs and with less obvious ones due to the distortions they introduce in the economy. These may include supply shortages, black markets, cutbacks in planned productive investments and increases in industry concentration. The longer WPC last, the more likely that some of the direct controls will outlive their original planned lifespan (rent control, freezes of university tuition fees, etc.). Further, it may be feared that in order to gain support for WPC from large labour unions or other pressure groups, they will be granted some long-term advantages from governments, bringing politicization of economic relationships. Public discussions of the possibility of their introduction might indeed push wages higher faster and a proposed ceiling may become the norm even for wage contracts that otherwise would have been agreed upon at a lower rate.

In the current episode, inflation, fuelled by a global flood of policy stimulus to offset the effects of the pandemic on output and employment, took off as money supply increased dramatically. Supply-chain disruptions and the Ukraine war only made matters worse against a backdrop of deglobalization and rising populism that have reduced potential output growth and compounded the risk that inflationary pressure will persist. That would make low inflation even harder to achieve and sustain. Under these conditions, the opportunity cost of bringing inflation back to the 2% target shared by many central banks may prove quite high. For example, Domash and Summers (2022) summarize the unemployment trade-off for containing inflation in the U.S. as follows: “a gradual approach would call for five years of 6% unemployment, while a more rapid return to target could be achieved by driving up rapidly the unemployment rate and maintaining it at 10% for one year.” It should be noted that in the Fed’s latest Summary of Economic Projections, the median projection shows the Fed achieving inflation of 2.2% by December 2024, with an unemployment path of 3.7% at year end 2022, 3.9% at year end 2023 and 4.1% in 2024. This sounds quite optimistic next to Domash and Summers. Rule of thumb suggests that an unemployment rate of 10% to 11% would have 12 million more workers claiming unemployment insurance benefits, assuming a 1% decline in the participation rate.

In these circumstances, it is not surprising to hear some pundits calling for a serious debate about using strategic price controls instead of blindly calling for tight monetary policy. Isabella Weber, an economist at the University of Massachusetts Amherst, is a strong voice for that view. She argues “that currently a critical factor that is driving up prices remains largely overlooked: an

explosion in profits." She believes "large corporations with market power have used supply problems as an opportunity to increase prices and scoop windfall profits." We must admit that economic theory suggests price controls tend to work better in imperfectly competitive markets. In extreme cases, such as a monopoly, price control can be beneficial. The monopolist, as the sole seller of a product, will maximize profits by selling smaller quantities of a good at a higher price than could be obtained in a competitive market. If governmental intervention caps the price at which the monopolist may sell at a point below the current price, then to maximize profits the monopolist will have to sell more at the lower price. An outcome that should be beneficial to consumers.

Before taking one side or the other in the current debate, we suggest a look at what can be learned from the experience of the 1970s.

U.S.: The great inflation of the 1970s

A vast literature has been produced on the great inflation of the 1970s. Most of it takes the view that U.S. monetary policy was, in retrospect, too expansionary in that decade. Policymakers were at the time wrongly convinced that unemployment was above NAIRU, in other words that the economy was running below potential, when in fact it was not. Facing persistent inflation despite the perceived output gap, they became more pessimistic about the effectiveness of economic slack in reducing inflation. Many quotes from the FOMC minutes or the Economic Report of the President support that statement. For example, in 1971 Fed chairman Arthur F. Burns judged that monetary policy could do very little to arrest an inflation that rested so heavily on wage-cost pressures. In his judgment a much higher rate of unemployment produced by monetary policy would not moderate such pressures appreciably (FOMC minutes June 8, 1971 p. 51).

Over time, the cost-push view of inflation gained support. After all, it could explain the coincidence of negative output gaps and high inflation.

According to Romer 2002, this led policymakers "to pursue a two-pronged strategy. One prong was highly expansionary fiscal policy (Economic Report of the President 1972 p. 108) that resulted in a sharp swing in the high-employment surplus toward deficit in 1971. Since policymakers had come to believe that slack would do little to reduce inflation, they saw no reason to tolerate unemployment above the natural rate. The other prong was wage and price controls to give the country a period of enforced stability in which expectations, contracts, and behavior will become adapted to the fact that rapid inflation is no longer the prospective condition of American life."

Clearly, in retrospect, a combination of faulty output-gap measures and a cost-push interpretation of the inflation dynamic resulted in policy responses that were not restrictive enough to lower inflationary pressures. Thus we are not surprised that investigations of the impact of wage and price controls in the United States, using VaR method to generate a counterfactual benchmark, show that controls held down inflation only temporarily. They accordingly failed to shift inflation to a low and stable path in the years immediately following decontrol.

The Canadian experience

Leading up to the Government of Canada's announcement of its anti-inflation program (AIP) in October 1975 were price inflation running above 10% and new collective labour agreements calling for wage increases in the neighbourhood of 20% from the fourth quarter of 1974 through the third quarter of 1975. The implicit aim of the three-year program of income and price controls was to support fiscal and monetary policies in reducing inflation. From the protection factors used to calculate the compensation guidelines, it can be inferred that the AIP's inflation targets for the first, second, and third years were 8%, 6%, and 4%.

In a 2005 Bank of Canada working paper, John Sargent noted that "a number of econometric studies have concluded that the controls exercised a significant independent effect in lowering rates of wage increase: Most [studies] conclude that the AIP [the controls element] lowered wage increases by 2.5 to 4 per cent during the three years it was in operation. It is estimated that a comparable reduction in wage inflation by means of monetary restraint alone would have required unemployment rates of approximately 12 to 13 per cent [recognized as possibly subject to some overestimation], as compared with the 7 to 8 per cent actually experienced." Sargent also refers to estimates from Wilton (1984) which indicate that "price inflation would have been 1-2 per cent higher in each of 1977, 1978 and 1979 in the absence of controls."

There was, according to Wilton, little independent effect on prices in the first year of the program because existing wage contracts were not abrogated. Wilton's view is that the effect on price inflation peaked in 1979, the year following the end of the program. Yet the 12-month changes in the consumer price index in 1977, 1978, 1979 and 1980 were 9.4%, 8.6%, 9.8% and 11.1%



respectively, well above the implicit targets of the AIP. Despite that failure, Cousineau and Lacroix (1978) argue that when the focus is put on the rate of money wage increases in major collective agreements rather than on the CPI, it could be said that AIP had a positive effect. By their estimates, the rate of money wage increases from the fourth quarter of 1975 to the first quarter of 1977 was on average 1.7 percentage points lower in the private sector and 4.3 points lower in the public sector than their models suggest they would have been without AIP. Thus one's view of the merit of AIP might depend on the benchmark against which it is measured ...

Controls on the front burner again

Over the years, conventional wisdom and understanding of inflation have evolved. Nowadays no one questions whether central banks have the tools to bring inflation under control. The debate was settled in the early 1980s by Paul Volcker with his cold-turkey approach. It did deliver on the inflation front. But Volcker's successes were not achieved without bringing some fears of financial and economic Armageddon. The world economy went through a wave of debt crises in developing countries, especially in Latin America, that nearly brought down the largest U.S. banks. Further, high real interest rates and the 1982 recession contributed to widespread deindustrialization, particularly in the Midwest, along with unemployment above 10% in 1982.

Considering the limited ammunition that will be at the disposal of monetary and fiscal authorities to take the economy out of a potential downturn, are wage and price control an alternative? We think not. Instead of relying on populist measures and resorting to WPC that would only temporarily limit inflation, policymakers should implement sound monetary and fiscal policy to lean against the wind and use the limited bullets at their disposal to create conditions fostering business investment to increase the potential of their economies.



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Economics and Strategy

Montreal Office

514-879-2529

Stéfane Marion

Chief Economist and Strategist
stefane.marion@nbc.ca

Kyle Dahms

Economist
kyle.dahms@nbc.ca

Alexandra Ducharme

Economist
alexandra.ducharme@nbc.ca

Matthieu Arseneau

Deputy Chief Economist
matthieu.arseneau@nbc.ca

Daren King

Economist
daren.king@nbc.ca

Angelo Katsoras

Geopolitical Analyst
angelo.katsoras@nbc.ca

Jocelyn Paquet

Economist
jocelyn.paquet@nbc.ca

Toronto Office

416-869-8598

Warren Lovely

Chief Rates and Public Sector Strategist
warren.lovely@nbc.ca

Taylor Schleich

Rates Strategist
taylor.schleich@nbc.ca

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