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.
Bibliography

- Carr, Jack, “Wage and Price Controls: Panacea for Inflation or Prescription for Disaster?” The Fraser Institute 1976
- Federal Reserve Board, “Economic Projections,” June 2022
- Malmendier, Ulrike, “Experiencing Inflation: The Role of Inflation Expectations in Monetary Policymaking,” ECB Forum on Central Banking, June 29, 2022
Special Report
Economics and Strategy

Montreal Office
514–879–2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau
Deputy Chief Economist
matthieu.arseneau@nbc.ca

KYLE DAHMS
Economist
kyle.dahms@nbc.ca

Daren King
Economist
daren.king@nbc.ca

Alexandra Ducharme
Economist
alexandra.ducharme@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@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

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

General
This Report was prepared by National Bank Financial, Inc. (NBF), (a Canadian investment dealer, member of IIROC), an indirect wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on the Toronto Stock Exchange.

The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete and may be subject to change without notice. The information is current as of the date of this document. Neither the author nor NBF assumes any obligation to update the information or advise on further developments relating to the topics or securities discussed. The opinions expressed are based upon the author(s) analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein, and nothing in this Report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient’s individual circumstances. In all cases, investors should conduct their own investigation and analysis of such information before taking or omitting to take any action in relation to securities or markets that are analyzed in this Report. The Report alone is not intended to form the basis for an investment decision, or to replace any due diligence or analytical work required by you in making an investment decision.

This Report is for distribution only under such circumstances as may be permitted by applicable law. This Report is not directed at you if NBF or any affiliate distributing this Report is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. You should satisfy yourself before reading it that NBF is permitted to provide this Report to you under relevant legislation and regulations.

National Bank of Canada Financial Markets is a trade name used by National Bank Financial and National Bank of Canada Financial Inc.

Canadian Residents
NBF or its affiliates may engage in any trading strategies described herein for their own account or on a discretionary basis on behalf of certain clients and as market conditions change, may amend or change investment strategy including full and complete divestment. The trading interests of NBF and its affiliates may also be contrary to any opinions expressed in this Report.

NBF or its affiliates often act as financial advisor, agent or underwriter for certain issuers mentioned herein and may receive remuneration for its services. As well NBF and its affiliates and/or their officers, directors, representatives, associates, may have a position in the securities mentioned herein and may make purchases and/or sales of these securities from time to time in the open market or otherwise. NBF and its affiliates may make a market in securities mentioned in this Report. This Report may not be independent of the proprietary interests of NBF and its affiliates.

This Report is not considered a research product under Canadian law and regulation, and consequently is not governed by Canadian rules applicable to the publication and distribution of research Reports, including relevant restrictions or disclosures required to be included in research Reports.
UK Residents

This Report is a marketing document. This Report has not been prepared in accordance with EU legal requirements designed to promote the independence of investment research and it is not subject to any prohibition on dealing ahead of the dissemination of investment research. In respect of the distribution of this Report to UK residents, NBF has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). This Report is for information purposes only and does not constitute a personal recommendation, or investment, legal or tax advice. NBF and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant investments or related investments discussed in this Report, or may act or have acted as investment and/or commercial banker with respect hereto. The value of investments, and the income derived from them, can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance. If an investment is denominated in a foreign currency, rates of exchange may have an adverse effect on the value of the investment. Investments which are illiquid may be difficult to sell or realise; it may also be difficult to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain transactions, including those involving futures, swaps, and other derivatives, give rise to substantial risk and are not suitable for all investors. The investments contained in this Report are not available to retail customers and this Report is not for distribution to retail clients (within the meaning of the rules of the Financial Conduct Authority). Persons who are retail clients should not act or rely upon the information in this Report. This Report does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

This information is only for distribution to Eligible Counterparties and Professional Clients in the United Kingdom within the meaning of the rules of the Financial Conduct Authority. NBF is authorised and regulated by the Financial Conduct Authority and has its registered office at 70 St. Mary Axe, London, EC3A 8BE.

NBF is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

U.S. Residents

With respect to the distribution of this report in the United States of America, National Bank of Canada Financial Inc. ("NBCFI") which is regulated by the Financial Industry Regulatory Authority (FINRA) and a member of the Securities Investor Protection Corporation (SIPC), an affiliate of NBF, accepts responsibility for its contents, subject to any terms set out above. To make further inquiry related to this report, or to effect any transaction, United States residents should contact their NBCFI registered representative.

This report is not a research report and is intended for Major U.S. Institutional Investors only.

This report is not subject to U.S. independence and disclosure standards applicable to research reports.

HK Residents

With respect to the distribution of this report in Hong Kong by NBC Financial Markets Asia Limited ("NBCFMA") which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 (dealing in securities) and Type 3 (leveraged foreign exchange trading) regulated activities, the contents of this report are solely for informational purposes. It has not been approved by, reviewed by, verified by or filed with any regulator in Hong Kong. Nothing herein is a recommendation, advice, offer or solicitation to buy or sell a product or service, nor an official confirmation of any transaction. None of the products issuers, NBCFMA or its affiliates or other persons or entities named herein are obliged to notify you of changes to any information and none of the foregoing assume any loss suffered by you in reliance of such information.

The content of this report may contain information about investment products which are not authorized by SFC for offering to the public in Hong Kong and such information will only be available to, those persons who are Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong ("SFO")). If you are in any doubt as to your status you should consult a financial adviser or contact us. This material is not meant to be marketing materials and is not intended for public distribution. Please note that neither this material nor the product referred to is authorized for sale by SFC. Please refer to product prospectus for full details.

There may be conflicts of interest relating to NBCFMA or its affiliates’ businesses. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by NBCFMA or its affiliates, or in other investment vehicles which are managed by NBCFMA or its affiliates that may purchase or sell such securities and instruments.

No other entity within the National Bank of Canada group, including National Bank of Canada and National Bank Financial Inc, is licensed or registered with the SFC. Accordingly, such entities and their employees are not permitted and do not intend to: (i) carry on a business in any regulated activity in Hong Kong; (ii) hold themselves out as carrying on a business in any regulated activity in Hong Kong; or (iii) actively market their services to the Hong Kong public.

Copyright

This Report may not be reproduced in whole or in part, or further distributed or published or referred to in any manner whatsoever, nor may the information, opinions or conclusions contained in it be referred to without in each case the prior express written consent of NBF.