CAN THEORY REALLY SUPPORT POLICY?

11 CAN INFLATION BE PROHIBITED[1]
– A Study on Price Controls in Sweden

by Bo Axell

In recent years liberal economic-political ideas have experienced a renaissance. A fundamental liberal idea is that the resource allocation problem should be solved by means of market mechanisms and with a minimum of public involvement. On the other hand, many claim that the problems with high inflation and unemployment in Sweden and in many other western economies have to be solved with the help of precise fine-tuned public intervention.

Models of Market Pricing

Models of free market pricing have been developed at IUI within the project "Price Controls in Sweden" (see for instance Albrecht-Axell-Lang, QJE 1986). Other projects like the "Micro- macro Model project" (see Eliasson 1985) also provide a free market approach to macro modelling based on micro behavior.

These theories are presented together with other contributions in recent years to the economic theory of price- and wage formation. The book "*Can inflation be prohibited?*" therefore includes a survey of the different theoretical approaches during the seventies and eighties, especially the search theoretical approach.

To evaluate the effects of price controls, a "general" theory of inflation is needed as a reference. Such a theory, based on Knut Wicksell's ideas from the turn of the century, is used to explain movements of the general price level (inflation) and the distortion caused by price controls.

[1] Swedish title: *Kan inflation förbjudas? Om fri eller reglerad pris- och lönebildning,* IUI, Stockholm.

Regulation of Interest Rates and the Exchange Rate

The main conclusion is that price controls are useless as a means to contain inflation. Instead, they *cause* inflation.

There are three main sources of inflation: (1) investment in excess of savings, (2) export surpluses, and (3) public deficits. All three represent a form of price control where the "price" has been regulated to a level below the market level.

Investment in excess of savings is caused by a rate of interest, set – by the Central Bank – at a level below ex ante rates of return by investors, or what Wicksell called the natural rate of interest. Export surpluses are generated by exchange rates that are too low, because of devaluations or exchange rate controls. Public expenditure surpluses or budget deficits occur when the charges for public services are too low, and an excess demand situation is created. The charges on public services include both direct fees and tax rates.

These imbalances together determine the rate of inflation. Low tax rates can be offset by high interest rates and inflation is avoided. Welfare losses may then occur, however, because of insufficient investments.

Summing up, if the rate of interest, the exchange rate and/or price on public services and taxes are set too low by regulation, the combined effect is that they *cause* inflation.

General Price Controls

An econometric model based on the above principle has been used to study the five quarter long general price control of 1970-71. The analysis shows that prices in general increased at least as much as they would have increased without price controls. In addition, inflation was significantly higher than the model predicted two years after the price control period. The probable explanation is that the general price-control was interpreted as an announcement of a new policy. Earlier price controls had been restricted to emergency situations. The new policy made firms set prices higher than before. Hence price controls are more likely to *cause* inflation than to stop it.

The Allocation Effects of Price Controls

Can price controls of any kind improve welfare in the economy? The book demonstrates that this is possible, but not likely.

Only recently has theory been able to predict the outcomes with respect to resource allocation in an economy completely left to "itself" to determine *what* to produce and *how* to produce. The traditional general equilibrium solution with a single price is not obtained unless price-making is performed by an auctioneer or a central "price controller", or at zero information collection costs.

Rather we get a solution with price and wage *distributions* when there are information collection costs (see Albrecht-Axell-Lang, QJE, 1986). This implies that the optimality in the allocation of resources usually associated with the free market economy does not necessarily hold. The consumption of resources in the allocation process itself is large. If this resource use could be reduced by means of public intervention, then the market solution by definition is not optimal.

Price dispersion signals that the price system has not been able to transmit all information in the economy to market agents. Suboptimal economic performance occurs and should be interpreted as a cost.

Hence, price and wage dispersion is the cause of resource consumption. In principle, it should then be possible to improve resource allocation through intervention in the free formation of prices in a way that decreases the variances in the distributions, reduces resource-consumption in the allocation process (unemployment, for instance) and increases total production.

This conclusion, however, overlooks the fact that public interventions are also costly. Public controls, contrary to market search, draw resources directly. In addition, mistaken or mis-directed, public controls will cause distortions or allocation losses which may be quite large. A correct evaluation of the macro economic effects of price controls therefore requires that the relative efficiency of information use in a free market economy is compared with an administered (price controlled) economy. This is currently beyond the frontier of research.

References

Albrecht, J. – Axell, B. – Lang, H., 1986, "General Equilibrium Wage and Price Distributions", *Quarterly Journal of Economics,* Vol. CI, Nov., pp. 687-707.

Eliasson, G., 1985, *The Firm and Financial Markets in the Swedish Micro-to-Macro Model – Theory, Model and Verification,* IUI, Stockholm.