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After the Freeze

WILLIAM POOLE HAS OFFERED a model of incomes policy that is like balancing an egg. The policy can be far too oppressive—the egg falls left; or it can be totally ineffectual—the egg falls right. Finding a middle approach for policy that works is like trying to stand the egg on its head: It's clearly unstable and can't be done.

I don't think anyone in the administration is contemplating a permanent, comprehensive set of controls. And it is certainly not the program that I am prepared to defend or that most economists who favor an incomes policy of some sort have in mind. What is relevant is a middle-of-the-road program that can be adopted after the ninety-day freeze. Whether the middle road on incomes policy can work depends on the environment it has to work in. My view of the environment is different from Poole's. In the sand, the egg stands on its head very easily.

Recently I wrote about structural changes that have led to a deterioration of the tradeoff between inflation and unemployment.[1] There I developed measures of labor market tightness that took account of these changes and showed that labor markets had been extremely tight during the 1966–69 period. An inflation model based on these measures explained the rapid increase of wages and prices over this interval and through the first half of 1970. But even the structural changes identified there do not account for the rate of inflation the United States has been suffering recently. Labor

1. George L. Perry, "Changing Labor Markets and Inflation," *Brookings Papers on Economic Activity* (3:1970), pp. 411–41.

markets are not tighter now than they were in 1965, even by my measures. Operating rates are not higher now than in the early 1960s. There is no way today's inflation can be seen as a result of tight labor markets or excess demand in product markets; those conditions exist in only a few isolated sectors of the economy. Nor can today's inflation be explained by the weight in the wage index of long-term wage settlements that are still catching up for past inflation, although these headline makers may have important indirect, demonstration effects.

Although the concept lacks theoretical elegance, I am persuaded that inflation is now perpetuated to an important degree because of high "habitual" rates of wage and price increase. Although we conceal a lot of our ignorance about the inflation process when we employ past changes in wages or prices to help explain the present, we have to attribute a large impact to recent experience in order to explain today's situation. But the present rapid wage increases need not imply that shifts have occurred in some well-defined labor supply curve that would lead to a model of accelerating inflation. I see no evidence for this interpretation and choose the description "habitual" to emphasize this. If this habitual situation in wage setting is interrupted, there need be no consequences for real output and employment. I am offering a treadmill explanation of the present situation. A middle-road incomes policy is designed to get us off the treadmill, down to a lower habitual average rate of wage and price increase.

In this environment, I cannot share Poole's misgiving about a middle-road incomes policy. He fears that a policy that is enforceable only against large firms and unions would find controlled firms unable to meet the demand for some of its products. In this situation, he sees customers forced to switch their purchases to uncontrolled firms, and this development leading either to broader controls or to their complete abandonment. In today's economy, would this really be a problem? Not only are markets not tight enough, but controls need not be so rigid.

I am not dissuaded by Poole's finding that, for nineteen out of ninety-eight product categories, wholesale prices rose more than 7 percent during the past year while average wholesale prices rose only 3.6 percent. Some of the nineteen were agricultural products, raw materials whose prices are set in world markets, or products fabricated from them. Some may have been industrial products whose price increases resulted from increased labor costs. We do know that the first-year cost of many wage increases was more than 3.4 percent above the average rate of wage increase. And we know that long-run productivity experience varies substantially among individual industries, so that any given change in hourly wage costs is translated into widely differing changes in standard unit labor costs. Thus Poole's reported dispersion in price behavior makes a good case for flexible controls and intelligent price guidelines. But it does not persuade me that suppressed excess demand would be a problem. We could, of course, create that problem for ourselves—say, by trying to hold the price of lumber in the midst of the current housing boom. But that straw man should not be the subject of discussion.

If the nation can emerge from the ninety-day freeze with a deescalation policy aimed at wages and prices broadly but, in practice, enforceable only in labor and product markets where market power is considerable, I would expect favorable results and only small costs. To opt for this kind of program is not to imply that oligopolistic industries and powerful unions are the main cause of the inflation. But they are a good place to concentrate an incomes policy for several reasons.

If we are to slow down the treadmill, highly visible price and wage situations are the one place in which the government can call attention to the new rules and show it means business. This kind of demonstration should help reduce the present "habitual" rate of price and wage increases in other sectors as well. I would expect weak markets over a long enough period to do it too. But that seems to be a long and costly process.

Furthermore, while these concentrated sectors did not give birth to the inflation, they have been an important factor in keeping it so healthy. Having been late to get started and having finally caught up, they are unlikely, of their own accord, to lead the way down toward price stability. That is not what union members pay their dues for. I find it somewhat contradictory that the same observers who doubt that such a limited incomes policy could work frequently stress structural changes to diminish market power among concentrated industries and unions as a longer-run inflation cure.

Finally, I want limited and flexible controls because I do not want more. A price-wage board can hope to exercise control in these visible sectors and do so in a fairly flexible way. They can consider ten appeals a month with some care. They cannot sensibly monitor prices and wages everywhere. I am against comprehensive controls just as Poole is and for the same reasons. The initial ninety-day freeze is short enough—and voluntary enough—to pose no serious problems of efficiency. It may have been the best way to start off. But I want to emerge from it with a limited and flexible system.

The circumstances behind the present inflation make this a particularly favorable time for such a limited program. With excess demands virtually absent, it is hard to visualize significant misallocations arising from a wage standard that deescalated average wage increases to, say, a 5 percent annual rate. Why should we expect to see the steel companies, who are under scrutiny, lose workers to small, competitive firms who are not? Firms have been granting large wage increases because they have become the general pattern. If the treadmill slows, so does the wage increase that an individual firm must grant to meet its labor requirements. To raise wages faster than this, firms would have to behave irrationally just because they are not under the scrutiny of controls.

Of course, there will be some reallocations through changing relative wages, but they do not require today's average inflation rate. Resources were reallocated in the early 1960s with no loss of efficiency and with a stable price level. Nor need the resource transfer be a flow governed by wage movements in the uncontrolled sector alone. A flexible control system would permit promotions, competition for particular skills in short supply, and similar departures from any general rule.

Under a new incomes policy, I expect prices generally to be governed by costs and so to present no special problem. For the areas where market power is great, a price-wage board would monitor price movements. While excessive price increases in oligopolistic sectors are not the main cause of the recent inflation, there are reasons to guard against them: First, it is important to demonstrate an evenhanded treatment of wages and prices under the incomes policy; second, we want to ensure a prompt pass-through of cost moderation into prices; third, we want to avoid the occasional instance in which administered pricing might contribute independently to inflation. The biggest problems would come from a few sectors in which classical market power is not the issue but in which prices have been rising inordinately for special reasons. If allowed to continue, these increases would make cooperation under the incomes policy in other sectors more difficult. For example, medical costs have been rising rapidly. Here the government could slow price increases by using its control over the medicare and medicaid programs.

A more difficult problem for incomes policies arises when the economy expands more and markets begin to tighten. Even here, an incomes policy should be helpful, just as I believe the guideposts were helpful in their day despite their almost totally voluntary nature. What we see as a fairly gradual tradeoff curve between inflation and aggregate market tightness arises, I believe, as an increasing fraction of only loosely connected individual markets grows tighter. Adjustments among the markets takes place continuously through changing relative wages and prices. As the fraction of tight markets grows, the price changes average out to be more inflationary. On this highly simplified view, an incomes policy that modified the absolute price increases in the tighter sectors could still permit the needed adjustments, but with less net price increase than now occurs. An incomes policy need not break down until a substantial part of the economy experienced excess demand and certainly not before markets grew much tighter than they are today.

If over the next year the price deflator for the private sector could be slowed to a 2½ percent rate of increase while real output grew at a rate that noticeably reduced unemployment, the policy would have been a clear success. Before the new initiatives, there was virtually no sign of slowdown in the inflation rate, and policy makers seemed inhibited from stimulating the economy to speed up real growth by the fear of worsening the inflation. Over the last four quarters, real gross national product grew only 2.2 percent. Even a doubling of that rate of expansion would merely have held unemployment rates near recent levels, and there was little sign that the expansion would be faster than that.

Since there are other papers in this volume dealing with whether a continued high rate of inflation is tolerable, I will not address the question of living with what we have versus trying to correct it. An incomes policy imposes some costs, so if inflation is really costless, we should not have one. But I take it for granted that policy will fight against a rate of inflation like the current one. This means the choice we face is between an incomes policy and letting our concern over inflation take the unemployment rate where it will. Poole's optimism that a "do nothing" policy will achieve a good result is hard to accept, not only because the result is not assured, but because the price of waiting for something good to happen is so high. I am not a sailor, and Poole is an expert, so it might be wiser to forgo his sailing analogy. Nevertheless, I always thought that on a serious voyage, sailors carried a small motor on board precisely so that they would not be at the mercy of the winds. The economic winds have not been blowing favorably, and a firm incomes policy seems a good way to stop our drifting for now.