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How not to get inflation under control

Rising inflation has opened up a debate over state intervention to tackle the issue with price controls. But this could have the opposite effect

Steep energy bills, global delivery bottlenecks, and higher costs from containing the spread of Covid-19 have led to skyrocketing prices and worried consumers. Soaring inflation has led to demands for the state to intervene – by banning price increases or setting prices. Price controls sound like a good way to prevent further price hikes. The question, however, is whether the state is the right actor to combat the symptom of excessive inflation.

In general, first-semester economics applies here: in perfect competition, companies cannot arbitrarily set their prices higher, otherwise the competition will knock them out of the field. They are 'price takers' and the price of their goods and services corresponds to their (marginal) production costs. Price regulation by the state therefore reduces supply when revenues no longer cover the costs of production. The result, then, is empty shelves and an unregulated black market with very high prices. This will sound familiar to many Germans, because both were bitter realities in one part of the country until 1990.

Why, then, one wonders, is this proposal now being lively discussed again, when economic theory and experienced reality coincide as they rarely do?

Balancing the positives and negatives

Nevertheless, it is worth taking a closer look at the proposal. One argument of the advocates of price regulation is that there is no perfect competition in all sectors of the economy. In markets where there is only one or a few large suppliers, companies can indeed make high profits by exploiting their market power or monopoly position and by charging prices above their (marginal) costs. This is the case in the energy sector, which is considered one of the main drivers of the current rise in inflation.

Proponents of price controls also argue that they reduce sharp price fluctuations like those observed for key construction materials and primary products. Price controls are therefore particularly attractive for important raw materials whose prices fluctuate strongly on the international markets. This increases planning security for households and producers.

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That said, there are also convincing counterarguments to price controls. For starters, it's difficult to know the real level of external prices. Getting that wrong would result in lower supply and even higher prices for the long-term. There is also the question of which goods and services should ultimately have price controls. Such a political determination opens the door to corruption and lobbying. Moreover, the question of whether state price corrections are legally compliant is likely to complicate their use. With the Berlin rent cap, a price control was only recently introduced in Germany, which was then overturned by the Federal Constitutional Court as unlawful.

Enforcing energy prices could be difficult because they're decided globally, with minimal influence from national and EU authorities. If Germany tried to dictate a fixed price to Gazprom, they'd just stop selling us natural gas.

Even when price controls are introduced with the best of intentions, they risk stifling growth and progress. This is partly because price controls shift consumption from non-subsidised goods to subsidised goods. In addition, price ceilings can squeeze producers' profit margins, thereby inhibiting investment and entrepreneurial activity, with negative effects on employment and productivity growth.

Lessons from Berlin's rent cap disaster

Let's take another look at the rent cap in Berlin, where from January 2020, no new base rents could go above €9.80 per square metre – except in buildings completed after 2014. The flat's location was irrelevant: Only the year of construction and the furnishings counted. Alas, what at first seemed like great help for tenants turned out to be a disaster. Demand rose sharply for renovated apartments in pre-war buildings whose rents were below those of new flats. But the supply declined because landlords chose to sell their properties or investors no longer

invested in the refurbishment of dilapidated flats in old buildings. At the same time, rents for newly built apartments rose astronomically and priced families with normal incomes out of the market. The rent cap exacerbated Berlin's rental housing shortage.

In some sectors, prices change for quite different reasons, such as manufacturing innovations or demographic and developmental trends that impact global demand. For example, the politically desired booming market for electric cars will continue to fuel demand for copper and lithium in coming years. Such shifts affect prices. For these to adjust, however, they must not be regulated.

The greatest danger at present is that rising inflation expectations could further fuel inflation.

In short, if the state intervenes with price controls to curb inflation, it could achieve exactly the opposite of what it actually wants and could in many ways harm the economy. Instead, other institutions should tackle the challenges.

On the frontline is the European Central Bank (ECB), whose primary goal is price stability. The central bank under its president Christine Lagarde must not let inflation expectations get out of hand. The greatest danger at present is that rising inflation expectations could further fuel inflation.

In addition to transparent communication with the public, it is also important that the ECB prepares for a faster, more restrictive change of course in its monetary policy, should this become necessary in the coming months. The mere fact that the ECB communicates transparently that it is preparing should improve confidence in the ECB as the guardian of price stability and anchor inflation expectations to the two per cent inflation target.

Meanwhile, to combat the abuse of market power, we've got the powerful and highly respected European Commission's Directorate-General for Competition, headed by Margrethe Vestager. If one of the causes of high inflation really is market power, the Competition Commissioner could tackle this problem much more effectively than any other institution.

Mesdames Lagarde and Vestager, please take the reins!



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