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The return of inflation:
Can we protect real incomes?

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Summary

- In market economies, where workers have some power to set wages, and firms have some power to set prices, rising inflation results from conflict between workers and firms over the distribution of output. In *open* market economies, part of the output produced domestically must be paid to foreign suppliers. Rising costs of imported inputs shrink the pie that domestic firms and workers share, and heighten the conflict between the two.

- In the 1970s, inflation was set in motion by the two oil shocks and became entrenched when conflict between firms and workers resulted in price-wage spirals. 'Stagflation' (high inflation and high unemployment) ended the post-war Keynesian consensus and facilitated the rise of neoliberalism. The subsequent policy stance tamed inflation and ushered in the era of 'Great Moderation', albeit at the expense of sluggish wage growth, and rising inequality.

- Protecting real incomes against inflation is a balancing act. Raising interest rates could cause excessive damage. Price controls should only be applied in exceptional circumstances. Automatic wage indexation may ultimately prove counterproductive for workers. Across-the-board price subsidies are wasteful, regressive, and provide perverse incentives. Income transfers and social pacts are more promising, although they may run against policy and institutional constraints.

Introduction

High inflation, virtually unknown in advanced economies since the 1980s, has made a comeback. In the Euro area, the Harmonized Index of Consumer Prices (HICP) rose by 10% in September 2022 relative to September 2021. Energy, and to a lesser extent food, are the main focus of current inflationary pressures, rising by 19.7% and 12.4% respectively between August 2021 and August 2022 (ECB, 2022).

The initial price hike was triggered in early 2021 by developments linked to the pandemic, from large disruptions in global supply chains to shifting demand for various goods and services (and, in the US, the generous Covid-19 economic relief programmes). However, the current sharp acceleration has been largely fuelled by the war in Ukraine. The pressures from this conflict, especially on energy prices, are not expected to subside any time soon, and even when they do, inflation in Europe is likely to remain higher than in recent decades.

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For one, the bottlenecks in global supply chains are not expected to be resolved for a while, and may even get worse. Climate change adds to these pressures. Extreme weather, especially droughts, damage harvests, reducing the supply of food. Water shortages lower river levels and constrain the transport of commodities, and of materials (e.g. coal) that might relieve dependence on Russian fossil fuels. Higher carbon prices (to discourage its use) and insufficient investment in renewable energy are also likely to push prices up.

Rising inflation stokes up public discontent, as it erodes the purchasing power of nominal (i.e. money) incomes. At a macroeconomic level, lower real incomes and higher uncertainty negatively affect aggregate demand. As households and firms spend less, job creation falters. To rein inflation in, central banks raise interest rates, which also reduces growth and causes unemployment to rise. What is more, rising inflation tends to be regressive: low-income households spend a greater share of their budget on energy and food, whose prices have increased faster (Claeys & Guetta-Jeanrenaud, 2022). Inflation also poses risks for the integrity of the Euro area. As the early years of the Euro demonstrated, member states differ in their institutional capacity to deal with inflationary pressures, which can result in current account imbalances, with asymmetric consequences for national economies (Watt, 2017). In short, the current episode of high and rising inflation is likely to exacerbate inequalities within and across member states.

Faced with inflation well above their target, central banks around the world are currently going into reverse from the loose policies they pursued over the last decade: asset purchases are being rolled back and increases in interest rates are being implemented. The policy reversal runs the risk of choking the recovery from the pandemic, without really addressing the roots of rising inflation, which in Europe are located on the supply side. Moreover, the monetary policy reversal creates financial stability risks, especially for governments who saw their public debt-to-GDP ratios rising as a consequence of the unprecedented public financial support programmes rolled out during the pandemic, and who are currently constrained to provide financial support to mitigate the impact of inflation and speed up the transition to alternative, greener sources of energy.

Unsurprisingly, the political salience of inflation has risen dramatically. High prices featured large in the run-up to the French presidential election in April 2022 and the Italian parliamentary election in September 2022, while in the US an ‘Inflation Reduction Act’ was passed ahead of the mid-term elections of November 2022.

In market economies, workers have some power to set wages, and firms have some power to set prices, rising inflation results from conflict between workers and firms over the distribution of output.

It is therefore no wonder that governments are caught between a rock and a hard place, as they try to reconcile competing objectives: protecting workers and lower-income households from rising prices, preventing imported inflation from spreading and becoming entrenched, avoiding a recession as central banks raise interest rates, and coping with the higher cost of servicing public debt. In meeting these objectives, different policy options are being deployed or considered, with different distributional implications.

Inflation poses dilemmas for labour unions too. Can real wages and jobs be both protected, and if so, how?

In this policy paper, we first explain where inflation comes from, and describe the policy context for dealing with it since the 1980s. We then critically examine the various policy options for mitigating the rise in prices and its impact on wage-earners and low-income households in Europe, assessing their relative merits, costs and feasibility. The final section concludes.

Inflation: a primer on causes and policy responses

What causes inflation?

Rising costs of imported inputs (e.g. Russian gas or Asian semi-conductors) effectively shrink the pie that domestic firms and workers have to share, and heighten the conflict between the two.

In market economies, where workers have some power to set wages (for example, through collective bargaining), and firms have some power to set prices, rising inflation results from conflict between workers and firms over the distribution of output (Rowthorn, 1977). In *open* market economies, where firms use imported inputs to production, whether raw materials (such as natural gas or oil), or intermediate goods (such as semiconductors), some part of the output produced domestically has to be paid to foreign suppliers. This then becomes a three-way contest over the distribution of output among firms, workers, and foreign suppliers. Rising costs of imported inputs (e.g. Russian gas or Asian semi-conductors) effectively shrink the pie that domestic firms and workers have to share, and heighten the conflict between the two. Depending on the balance of power, greater conflict may result in rising inflation.

Whether firms can pass higher costs to consumers by raising prices will depend on how much monopoly power they enjoy. [...] Similarly, whether workers can secure higher nominal wages will depend on their bargaining power over employers.

Whether firms can pass higher costs to consumers by raising prices will depend on how much monopoly power they enjoy: the lower the competition in product markets (for example, if only few firms supply a certain good, and/or in poorly regulated markets), the higher the firms' price-setting power, as is the case in some industries in some countries.

Similarly, whether workers can secure higher nominal wages will depend on their bargaining power over employers. Low unemployment, plentiful job opportunities, and generous social benefits when out of work, all tend to raise workers' bargaining power. So do strong labour unions, although the evidence also shows that when collective bargaining is coordinated, and unions are encompassing, wage demands tend to be more moderate, as unions balance the interests of their members with those of the unemployed, actual or potential (Soskice, 1990; Pekkarinen et al., 1992; Golden & Pontusson, 1992).

In the 1970s, the two oil shocks set inflation in motion, while conflict between firms and workers resulted in price-wage spirals, with deleterious effects on consumption, investment, growth, and employment. The resulting 'stagflation' (high inflation *and* high unemployment) ended the post-war Keynesian consensus and facilitated the rise of neoliberalism.

Compared to that previous high-inflation era, globalisation and deregulation in product markets have eroded the price-setting power of many firms, while deindustrialisation, deregulation in labour markets, and stricter social benefits have eroded the wage-setting power of workers. As a result, the risk of price-wage spirals is lower now than it was half a century ago.

Policy responses to inflation

In response to the stagflation of the late 1970s and early 1980s, and in a context of growing financialization, governments in many advanced democracies reformed the institutional set-up of central banks by vesting them with independence, plus a narrowly-defined mandate to maintain price stability, often interpreted as aiming for inflation below 2%.

In response to the stagflation of the late 1970s and early 1980s, governments in many advanced democracies reformed the institutional set-up of central banks by vesting them with independence and a narrowly-defined mandate to maintain price stability, often interpreted as aiming for inflation below 2%.

Central bank independence responded to a perceived need to strengthen the checks and balances of economic governance. This rested on an understanding that politicians seeking re-election are reluctant to inflict pain in the economy, whereas independent central bankers can be relied upon to break inflation spirals by raising interest rates, and therefore effectively engineering a recession, without fear of electoral retribution. By insulating central banks from political pressures, and by giving them free rein to pursue price stability, governments 'pre-committed' to low inflation. This helped 'anchor' expectations, among firms and unions, that inflation would remain low, even if unemployment had to rise (Rogoff, 1985).

Governments in Europe further signalled their commitment to low inflation first by pegging the exchange rate of their currencies to the German Mark, then by signing up for the Euro, and eventually by subordinating fiscal policies to the requirements of price stability. Policy reforms (liberalising capital movements, lowering employment protection, making social benefits stricter) further contributed to achieving price stability, ushering in the era of 'Great Moderation', albeit at the expense of persistently sluggish wage growth, and rising inequality.

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Protecting real incomes: assessing the options

Generally speaking, policy makers may attempt to (i) contain inflation by raising interest rates or, more directly, by controlling prices, (ii) alleviate the impact of inflation on household budgets through price subsidies or income transfers, and (iii) protect workers' real incomes via wage indexation and social pacts. We examine these options in turn, assessing their merits, their costs, and their distributional implications.

Containing price increases

<u>Monetary policy</u>

Raising interest rates has become the standard means of reducing inflation. Since summer 2022, central banks around the world have been doing just that, often by a lot, in the hope that higher interest rates will take the steam out of inflation pressures. This has done the trick in the past. Can it do so again now?

Raising interest rates is blunt (it affects aggregate demand rather than addressing the causes of rising prices) and slow (it takes time for interest rates to work their way through the economy). Also, there is scant evidence that price-wage spirals are a real risk in Europe. By engineering a recession, monetary policy is bound to cause higher

unemployment than would otherwise have been the case. In view of that, the incomes of wage earners as a whole, including those without a job, stand to lose out.

Moreover, raising interest rates can be criticised for doing nothing to fix the problems currently fuelling inflation, which in Europe are firmly situated in the supply side of the economy: the war in Ukraine and the sanctions against Russia have raised the cost of energy; extreme weather has pushed up food prices (and the cost of transporting coal on waterways); disruptions in global supply chains have affected commodity prices. Mitigating climate change and facilitating the energy transition will require huge investments on the part of governments, firms, and households. This task is already daunting as it is. Higher interest rates are bound to make it more daunting still, by both raising the cost of the necessary investments, and by limiting the scope for compensating the losers of the energy transition.

Besides, interest rate hikes also pose substantial risks to financial stability, especially after the accumulation of debt during the Covid-19 pandemic. The fact that central banks have been tightening their policies in an uncoordinated manner compounds the problem. In the Euro area, debt-servicing costs are set to rise asymmetrically, reducing the fiscal space available to governments, especially in the highly indebted countries which were worst affected by the Euro crisis and the pandemic, such as Italy or Greece.

Having central banks pursue their single-minded objective of bringing inflation down to 2%, and having governments subordinate fiscal policy to that end, may prove simply too costly.

In view of all that, conventional monetary policy is likely to be less effective, and to cause considerable collateral damage in terms of growth, jobs, incomes and financial stability, rendering it harder to justify.

More broadly, granting central banks independence, and delegating to them monetary policy decisions to maintain price stability, was a defensible option in the economic and political conditions of the 1970s and 1980s. Now that anti-systemic parties are on the rise across Europe, national economies have not quite recovered from the effects of the pandemic (and of the Great Recession), price rises are mostly driven by energy and food imports, while dealing with climate change requires massive investment, having central banks pursue their single-minded objective of bringing inflation down to 2%, and having governments subordinate fiscal policy to that end, may prove simply too costly.

Price controls

A temporary cap on the price of gas has been defended as the fastest and most effective way to limit the impact of rising prices of imported natural gas on the energy costs of firms and households. (Gas affects energy costs directly, e.g. when used for heating, and indirectly, when used for producing electricity.) For instance, in Spain and Portugal, the government has imposed a cap on the wholesale price of gas used for generating power in order to limit increases in electricity retail prices (Tillier & Hieminga 2022). A gas price cap, up to a ceiling, has also been recently discussed in Germany (Dullien & Weber, 2022; Bofinger, 2022). At EU level, calls to impose a cap on wholesale gas prices, by setting a maximum trading value at the Title Trader Facility, a virtual trading point for natural gas in the Netherlands, which sets the benchmark for gas prices the EU, have been partly met by the proposed Council Regulation of 18 October 2022.

The case for a price cap rests on its potential to reduce the windfall profits of energy companies, limit speculative behaviour in the markets where gas options are traded, and ensure that energy remains affordable for households and firms. Unlike higher interest rates, price controls address inflationary pressures at their root.

The pitfalls are significant. If set at a sufficiently low level, a price cap can result in limiting even further the quantity of gas supplied by exporters to Europe. While gas pipelines lock in producers to certain markets, liquefied natural gas is traded globally, so suppliers may simply shift their exports to other markets, making gas shortages in Europe even more acute. Also, when prices are kept artificially low, consumers have an incentive to consume more than they would do otherwise, compounding the shortage which led to the price increases in the first place. Lastly, a cap on the price of electricity reduces the incentive to switch to, and invest in, renewable sources of energy.

The market for European imports of Russian gas largely resembles a situation in which a monopsonist faces a monopolist - or rather it would, if EU member states agreed to procure Russian gas collectively.

The reason price controls are seriously considered at all, in spite of these drawbacks, is that the market for European imports of Russian gas largely resembles a situation in which a monopsonist faces a monopolist – or rather it would, if EU member states agreed to procure Russian gas collectively. The balance of costs and benefits is so delicate that a gas price cap will have to be carefully designed to minimise the risk of adverse unintended consequences.

Softening the impact of high prices

Faced with rocketing energy costs, what can governments do to alleviate the effect on consumers?

Price subsidies

Prices act as signals, which subsidies distort, diluting the incentive to consume less, and undermining policies to reduce energy dependency and to mitigate climate change.

One option for governments is to subsidize energy prices. For instance, in August 2022 the Greek government pledged to subsidize 94% of the increase in electricity bills, having already spent over 3% of GDP on energy price subsidies in the first half of that year (Ari et al., 2022, p. 23; see also Sgaravatti et al., 2022). Also, in September 2022 the UK government introduced an Energy Price Guarantee worth around £1,100 for a typical household (UK Government, 2022).

What are the disadvantages? The general objection is that price subsidies do nothing to address, and might aggravate, the discrepancy between demand and supply. Furthermore, price subsidies are typically non-targeted: they apply to all consumers, irrespective of income. As a result, their distributional impact is regressive: richer households consuming more receive a greater share of the implicit fiscal expenditure than poorer households consuming less. For instance, it has been estimated that half of the implicit transfer of the Energy Price Guarantee in the UK will go to the top half of the income distribution (Adam et al., 2022). Perhaps most importantly, prices act as signals, which subsidies distort, diluting the incentive to consume less, and undermining policies to reduce energy dependency and to mitigate climate change. The higher the rate at which prices are subsidized, the stronger the disincentive. Lastly, unlike price controls (that shift the cost to suppliers), price subsidies are funded by government. In view of these concerns, the IMF (Amaglobeli et al., 2022) has recently recommended that "countries with strong social safety nets [should] allow a full pass-through of higher international fuel prices to domestic users and provide targeted and temporary cash transfers to vulnerable households". (We discuss targeted cash transfers below.)

When the price hikes are huge, as is the case with Russian gas since the war in Ukraine, the social and political implications of a "full pass-through" are likely to be highly disruptive.

Nevertheless, when the price hikes are huge, as is the case with Russian gas since the war in Ukraine, the social and political implications of a "full pass-through" are likely to be highly disruptive. If price subsidies are deemed desirable, as is probably wise, they may still be designed so as to minimise their regressive impact (and reduce their fiscal cost). For example, the subsidised price for residential electricity enforced by the state

government of Lower Austria for one year from September 2022 only applies to 80% of average household consumption (Sgaravatti et al., 2022).

The fact that poorer families are more vulnerable to price rises strengthens the case for targeted income support over across-the-board price subsidies.

Income transfers

Rather than seeking to contain price increases, an alternative strategy would be to offer income support. Such support is typically limited (i.e. it covers less than the full cost of rising prices), and is targeted to low-income households. In response to the energy crisis, several governments around Europe have recently introduced compensatory measures in the form of one-off income transfers and social benefit increases (Sgaravatti et al., 2022).

As the income elasticity of energy and food is low, their relative weight in household budgets is inversely related to income. The fact that poorer families are more vulnerable to price rises strengthens the case for targeted income support over across-the-board price subsidies. Furthermore, income transfers may be presented to workers as a less inflationary alternative to wage indexation (discussed next).

Like price subsidies, income transfers come at a cost to the government budget. However, the fiscal cost of income transfers is typically lower than in the case of price subsidies.

The obvious disadvantage is that, like price subsidies, income transfers come at a cost to the government budget. However, the fiscal cost of income transfers is typically lower than in the case of price subsidies. Also, fiscal measures can be designed in such a way as to be budget neutral. An early example of this was the Italian government's decision in April 2022 to pay all workers earning less than €35,000 a year a lump-sum bonus of €200. Coverage was extended to non-standard workers, the self-employed, the unemployed, and recipients of social assistance (*Reddito di cittadinanza*). Its cost (€6 billion) was funded by a 25% tax on the windfall profits of energy firms over the preceding semester. It was acknowledged that, even though the bonus lacked somewhat in sophistication, it scored high on promptness, fairness and inclusiveness (Lucifora, 2022).

Compensating workers

Inflation erodes the purchasing power of nominal wages. This has implications for industrial relations. What are the options available to unions? What can governments and employers do to compensate workers?

Wage indexation

At first sight, indexing wage increases to price increases seems an obvious solution: failing to ensure that nominal wages rise in line with inflation amounts to accepting that real wages will in fact fall. Nevertheless, history suggests that the longer-term costs of wage indexation may be dire, including for workers.

In the intellectual context of the 1980s, wage indexation, whether pursued via collective bargaining, or institutionalised in automatic mechanisms, came to be seen as a failure, and was finally abandoned.

As explained earlier, the wage-price spiral of the late 1970s and early 1980s eventually caused a shift in opinion away from the previous concern with the perils of deflation (itself a legacy of the Great Depression of the 1930s), and towards a new concern with the perils of stagflation. The high unemployment and high inflation in the aftermath of the oil shocks of the 1970s destroyed the credibility of Keynesian demand management and set the stage for the ascendancy of supply-side economics, of which independent central banks single-mindedly pursuing price stability was but one element. In the intellectual context of the 1980s, wage indexation, whether pursued via collective bargaining, or institutionalised in automatic mechanisms (as in the case of *Échelle mobile* in France or *Scala mobile* in Italy), came to be seen as a failure, and was finally abandoned. At the same time, disinflation was pursued at a high cost for workers, in terms of rising unemployment and deregulation of labour market institutions. Paradoxically, indexing nominal wages to

prices eventually failed to protect real labour incomes (especially if the lost wages of unemployed workers are also taken into account).

Since inflation often arises from, and is perpetuated by, conflict between economic actors whose claims on output do not add up, an obvious solution would be a reciprocal commitment to moderate these claims.

Recent research suggests that the wage indexation mechanisms currently in existence in Europe are unlikely to trigger price-wage spirals (Checherita-Westphal, 2022; Koester & Grapow, 2021). On the one hand, the share of employees covered is relatively low, limited to public sector workers in some countries. On the other hand, energy prices are typically excluded from the price index to which wages are adjusted, which limits their effectiveness when inflation is driven by energy costs. There are no signs that a price-wage spiral is about to break out anywhere in the Euro area (although this has not stopped the ECB from raising interest rates).

Social pacts

Since inflation often arises from, and is perpetuated by, conflict between economic actors whose claims on output do not add up, an obvious solution would be a reciprocal commitment to moderate these claims in order to make them consistent with price stability. That was the intuition behind both the incomes policies of the 1970s, and the social pacts which contributed to meeting the Maastricht criteria for joining EMU in the 1990s (Fajertag & Pochet, 2000).

Employers could contribute to a grand bargain in response to the energy crisis by offering unions a greater commitment to sign collective agreements, to offer newly hired workers regular contracts, and to invest domestically.

Typically, by enforcing wage moderation, limiting real wage increases to labour productivity growth, social pacts involve unions accepting lower wage growth in exchange for some other benefit. In the 1970s, that benefit was the commitment on the part of employers to refrain from raising prices. That was also the case in the aftermath of the Maastricht Treaty, when taming inflation helped achieve the collective goal of securing EMU membership. Following unification, German labour unions agreed to accept that the trajectory of wage growth would remain below productivity growth for a number of years, in exchange for a commitment on the part of German firms to maintain employment in plants located in Germany rather than relocate in lower-wage countries (Dustmann et al., 2014).

In the current context, employers could contribute to a grand bargain in response to the energy crisis by offering unions a greater commitment to sign collective agreements, to offer newly hired workers regular contracts, and to invest domestically. Similarly, governments could help compensate workers for higher prices by using some of the fiscal space available to reduce taxes on workers or to increase social benefits.

The main weakness of social pacts is that they are highly demanding in terms of institutional capacity.

The main weakness of social pacts is that they are highly demanding in terms of institutional capacity. Specifically, they require that both labour unions and employer associations are both encompassing (i.e. they account for a large majority of all employees and firms respectively) and authoritative (i.e. they can successfully enforce moderation on their members). These conditions are often absent. In the longer term, governments could take steps to reinforce social actors' institutional capacity for social pacts by extending the coverage of collective bargaining.

An extra limitation is that, in contrast to the US, where inflation is more broadly-based, inflationary pressures in Europe are almost entirely imported from abroad, stemming from high energy and food price following the Russian invasion of Ukraine. In this context, clearly social pacts in the EU cannot affect the pricing decisions of e.g. Gazprom, though by fairly allocating the costs they might contribute to moderating the transmission of the original inflationary trigger to the wider national economy. Moreover, if successful, social

pacts could set a precedent for future challenges, for instance how to make the green transition just, or how to make the digital transition inclusive.

Conclusions

Can we protect real incomes from inflation – and if so, how? What are the pros and cons of the options available?

Given the trade-offs involved, protecting real incomes is a balancing act. Raising interest rates much further is likely to cause excessive damage, by choking the recovery but by complicating efforts to mitigate climate change. Price controls should only be applied in exceptional circumstances and be designed carefully to minimise side effects. Automatic wage indexation may ultimately prove counterproductive for workers. Across-the-board price subsidies are wasteful, regressive, and provide perverse incentives. Of all the policy options considered here, income transfers and social pacts seem most promising, although they may run against constraints, from overly constraining fiscal rules to weak institutional capacities. Nevertheless, these constraints need not be insurmountable. Moreover, easing them may help meet future challenges.

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