conservativehome

Ryan Bourne: The wage-price spiral explanation of inflation is a dangerous myth

By Ryan Bourne

June 29, 2022

Ryan Bourne is Chair in Public Understanding of Economics at the Cato Institute. "If wages continue to chase the increase in prices, then we risk a wage-price spiral," said Boris Johnson last week.

The Prime Minister was speaking in the context of the wage demands of rail workers and public servants, following Bank governor Andrew Bailey's call for private wage restraint more broadly.

Invoking this spectre is convenient for central banks and governments looking to shirk culpability for rising prices. But it risks blaming the victims of economic mismanagement as its cause.

The idea that wage-price spirals cause inflation – that higher prices lead to higher wage demands, which beget further higher prices and then higher wages again and again – is a long-standing myth, and a dangerous one given it can lead to such misguided policy.

Economically, showing that wage demands do not create inflation is fairly simple. Take a hypothetical company with a big, unionised workforce. Suddenly the union demands a competition-busting 20 percent pay rise, and the firm reluctantly acquiesces, raising its prices to compensate.

For a given level of total money expenditure in the economy (what we might dub "aggregate demand"), the business's higher relative price loses some custom. As the business cuts back on production in lieu of higher prices, workers are laid off.

Yet this increases the pool of labour available to other firms, reducing wages elsewhere. Lowering costs of production, this greater worker availability ultimately feeds through into lower prices for other businesses.

In other words, without an increase in economy-wide spending, workers in one firm demanding wage hikes don't generate price rises across the board. Inflation cannot originate from certain trade unions or greedy workers at particular companies.

It is a monetary phenomenon, of too much aggregate money expenditure (demand) chasing too few goods (supply). Why, then, does the idea of a "wage-price spiral" causing inflation persist?

As Milton Friedman wrote in 2005, for individual firms, it will no doubt seem as if the link between aggregate wages and prices is obvious. A manufacturer or a retailer will certainly observe that they must raise prices because of their own rising (or expected) expenses, just as workers will feel they must demand higher wages because of rising prices.

But their respective intuitions beg the question: what caused the rising wages or prices they are responding to? At some stage there must have been an overall increase in demand bidding up some price or workers' money wages.

The process of other prices (and wages) adjusting to this higher aggregate spending in the economy creates the appearance of a near-term causal feedback loop. But as Friedman concludes, "the ultimate source of the increase in price has been an increase in monetary demand." You cannot get further inflationary pressures from pay demands unless monetary forces accommodate them.

Worrying about wage-to-price passthrough after a period of excessively expansionary policy is therefore akin to lamenting gravity as the cause of hurtling to the ground after someone has thrown you from a plane. Encouraged by politicians such as Johnson, the wage-spiral concept encourages businesses and workers to blame each other, mistaking the consequences of inflation for its origins.

True, major supply-shocks to energy and food, as well as excessive monetary stimulus, have driven up inflation this time. Sustained inflation, though, can only come from excessive growth in money expenditures, requiring either a rapidly growing money supply or excessive money velocity. It cannot be caused by trade unions.

That is why in recent weeks Tim Congdon, the monetarist, has allied with left-wingers, such as Grace Blakeley, to dismiss Johnson and Bailey's calls for wage restraint as "wicked." To urge the working classes to bargain against their interests in the face of macroeconomic mismanagement is not just a losing proposition, but a mistake that could create a clamour for bad policy.

One risk is that it leads businesses and consumers to misdiagnose the issue, taking political pressure off Bailey to check any further inflationary pressure.

The bigger problem is that, as an inflation control strategy, voluntary wage restraint is futile: suppressing price or wage signals will not tame the monetary impulses, but will create ad hoc shortages and resource misallocation, perhaps even emboldening calls for price and wage controls.

Friedman analogised restraint of individual wages to quell inflation to the attempt to deflate a giant balloon by pressing down gently on one small corner of it. In an environment of higher money expenditures relative to output, all the self-sacrifice of certain workers on pay would do is leave employers with more money left over to bid up prices elsewhere. The aggregate inflationary impulse remains.

Blakeley and others err for the same reason in blaming "greedy corporations" and price mark-ups for inflation. Even if some businesses "exploit" the confusion of inflationary periods by jacking up prices, in the absence of higher spending, they cannot themselves raise aggregate prices.

What we are seeing is instead fairly intuitive. Excessive aggregate demand relative to supply pushed up prices, which tend to be less sticky (more flexible) than wages. This drives up mark-ups and profits, with wages then eventually adjusting to the higher spending levels over longer periods.

All this is not to say that overly aggressive union or worker pay demands in the face of inflation cannot be dangerous from a macroeconomic perspective. The risks they bring, however, are unemployment and job dislocation, not inflation.

As I've previously written, the most defensible argument for "wage restraint" is if Bailey believes that inflation expectations right now are too high. If workers think that inflation will be higher than the Bank's eventual outturns, and so demand higher pay, then the result would not be higher inflation, but more layoffs, as workers price themselves out of jobs.

Even if firms ultimately resist such wage demands, in fact, a world where workers feel like they are going to get less than they expect may cause a fall in the employment rate as more people opt to work less. The very best case for Bailey and Johnson's call for wage restraint then is not to interrupt a "wage-price spiral" that risks generating more inflation, but to urge wage restraint to help anchor inflation expectations and prevent a future fall in employment.

It's extremely generous to suggest, though, that the Prime Minister was invoking 1970s fears in the service of this more sophisticated argument. No, openly musing about wage-price spirals was meant to win political support for the government's industrial disputes.

There may be good economic reasons for real pay restraint for rail workers, given technological developments and the collapse in rail demand following the pandemic. Rising inflation is not one of them.

Ryan Bourne occupies the R. Evan Scharf Chair for the Public Understanding of Economics at Cato and is the author of the recent book Economics In One Virus. He has written on numerous economic issues, including fiscal policy, inequality, minimum wages, infrastructure spending, the cost of living and rent control.