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Free markets vs price caps: can either bring down inflation?

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Economists tend to be very black and white about price caps. To some, they provide a 'surgical approach' to tackling the very price increases driving inflation. To others, they are a recipe for trouble, and doomed to backfire. Look closer, though, and it all seems more of a murky shade of grey.

Economist Isabella Weber faced an unpleasant Twitter pile-on last year when she suggested price controls as a remedy for inflation (Paul Krugman called her article "truly stupid", and later apologised for his "tone"), but the idea gained more traction in the wake of soaring energy bills.

Capital Economics' chief economist, Neil Shearing, said that "most economists generally accept that the introduction of energy price caps and/or subsidies across Europe over the past year was the least worst policy option given the circumstances". And in the UK, ministers are now said to be 'in talks' with retailers about 'voluntary' price ceilings.

One of the strongest arguments against price caps is that they distort the price mechanism, blocking powerful signals about where resources are required. Following the reports, Julian Jessop, former chief economist at the free market IEA think tank warned against “clumsy attempts to fix prices”. Ryan Bourne, chair for the public understanding of economics at the Cato Institute, said that price caps could lead to “shortages of covered products, with demand shifting to uncapped brands or corner shops, pushing up prices there”.

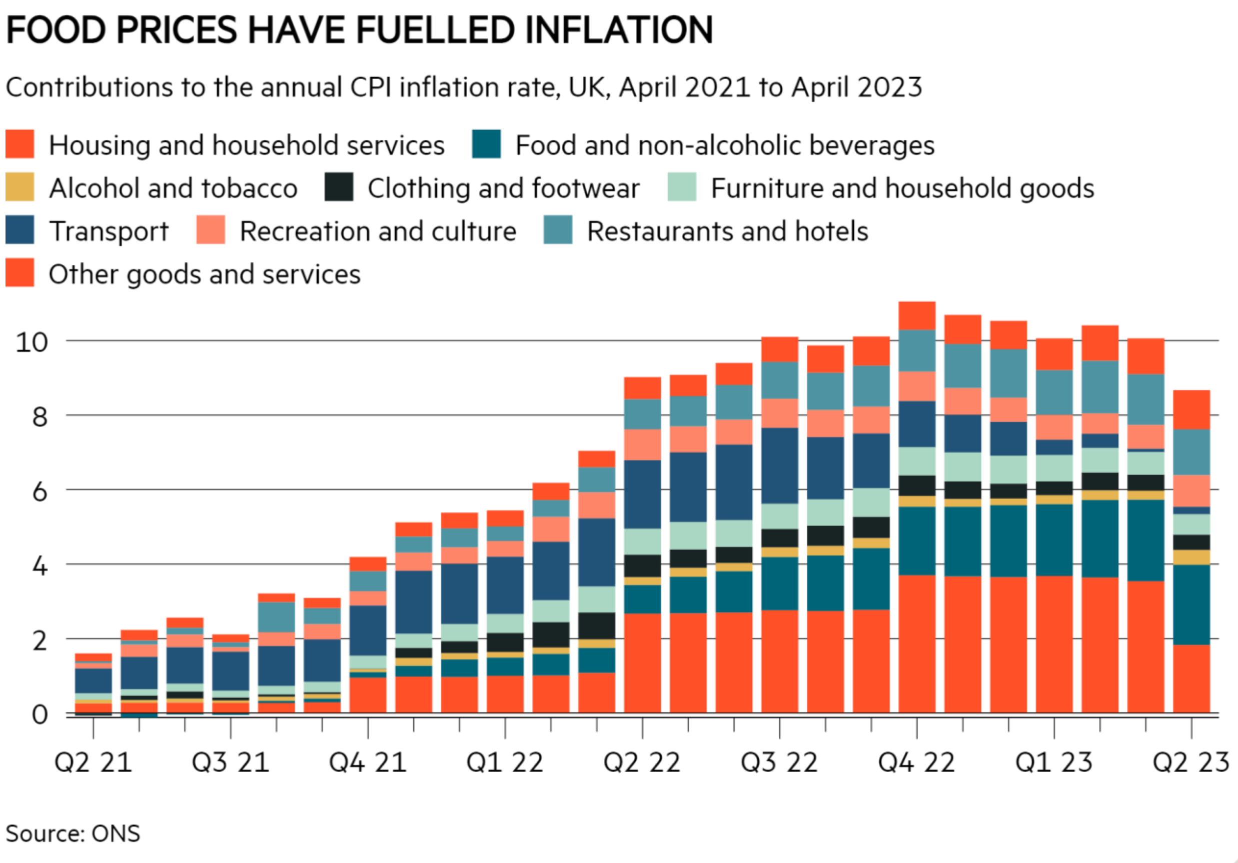
Jessop also warned of a raft of unintended consequences as a result of distorting price signals: supermarkets could use capped foods as loss leaders to gain market share from smaller shops – then try to recoup losses by raising the price of uncapped goods or reducing quality. We could see supermarkets treat a price cap as a ‘target’, rather than a ceiling, meaning prices aren’t cut even as costs fall. According to Jessop, a food price cap could even represent the “thin end of the wedge”, encouraging calls for more widespread intervention elsewhere in the economy.

Yet the price mechanism only communicates important information if the market is working properly. Even traditional textbook economics sets out that a price cap can actually improve economic efficiency in situations involving an abuse of market power.

Weber, along with fellow economist, Mark Paul, has previously argued that price controls have had a successful history in the US when used judiciously, and “while not a magic bullet, they are a powerful tool to tame inflation”. She added that “this is particularly true when market power – be it from landlords, oil companies or meat cartels – is at play”. With murmurs about ‘greedflation’ growing louder, could food price caps nip inflation in the bud by cooling one of its key drivers?

Though a powerful narrative, there seems to be limited evidence that ‘greedflation’ is having much impact today. Capital Economics said that the surge in food inflation is driven by poor harvests, disrupted wheat supply from Ukraine and high energy prices driving up the cost of food production. Recent OECD research found only modest evidence of higher profits, and most of this was concentrated in mining and energy companies. The body’s chief economist, Clare Lombardelli, told the *Financial Times* that “we don’t think [greedflation] is going to be an ongoing thing.”

As a result, we will probably find that food prices fall before any more radical policy interventions are made. Capital Economics’ Shearing said that “food inflation is likely to come down anyway without the imposition of price controls”, and he estimates that falling food inflation will shave about 1 percentage point off headline inflation by the end of 2023.



But this doesn’t mean that the market should be left to its own devices: there is agreement between economists that some form of intervention is needed. Jessop thinks that there may still be a case for “providing some extra help to poorer households who spend a larger proportion of their budgets on essentials like food”, while the OECD said last week that targeted government support to mitigate the impact of higher food and energy costs should still be available for “vulnerable households”.

According to Shearing, “the solution to this problem is to keep inflation expectations anchored and to deal with distributional challenges through fiscal transfers”. But as the past few weeks have shown, this is all a lot more difficult (and not to mention less headline-grabbing) than voluntary caps on the price of food.