

Notes On

WAGE INDEXATION: A MACROECONOMIC  
APPROACH

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## **Main Results:**

1. It is found that while indexing insulates the real sector from the effects of monetary shocks, it may exacerbate the real effects of real shocks.
2. The incentive to index is related to the variability of the price level, not to its mean rate or change
3. The optimal degree of indexation is partial, not full.
4. Indexing will not, in general, completely neutralize monetary variability; thus policies that bring about increased monetary uncertainty impose unavoidable costs on the economy.

## **Intuition behind theory:**

- The distinguishing feature of the analysis is the emphasis on real as well as monetary disturbances as a source of price and output variation.
- They use both real and monetary disturbances in their tests of indexation.

## **The model:**

- Simple neoclassical model modified to incorporate short term wage rigidities and uncertainty.
- Because indexing is designed to provide protection from unexpected movements in the price level, the model abstracts from anticipated changes and trends by assuming stochastic disturbances with zero mean.

## **Methodology:**

- They started with monetary shocks, and used their model to test the effects of an indexed wage and also the effects of a nonindexed wage. Next they tested real shocks and to determine the effects of indexed and nonindexed wages.
- They then model different ways to determine the optimal indexation degree.

## **Results:**

### **Monetary shocks:**

- In a non indexed economy, the real wage rate must fall in response to the assumed monetary shock.
- In an indexed economy, the indexing parameter is set at unity and the nominal wage rate is fully adjusted for changes in price level. The real wage rate is equivalent to what it was.
- In an indexed economy, monetary disturbances have no real effects. The real sector is insulated from the effects of monetary shocks in a fully indexed economy.

### **Real Shocks:**

- Real shocks are greater in an indexed economy than in a nonindexed economy.
- While indexing is an effective means of insulating the real sector from monetary shocks, it worsens the real effects of real disturbances. An economy subject to both real and monetary disturbances, there must exist a degree of indexing between zero and one.

## **Conclusions:**

- In an optimally indexed economy the real sector will not be fully insulated from the effects of monetary disturbances. This is because the optimal degree of indexing in such an economy is less than one if real shocks form part of the structure of the system.
- Indexing cannot, in general, completely neutralize monetary variability. They are implying that you still someone to subjectively implement monetary policy.