

indexing does seem to offer some relief from many of the social costs of inflation discussed in Chapter 16. As workers, firms, and lenders scramble to protect themselves against anticipated future increases in prices, current prices and interest rates will (increase/decrease) to reflect the expectation of inflation. If actual inflation turns out to be greater or less than expected, there will be a redistribution of wealth that many feel is essentially arbitrary. Legal prohibitions on nominal interest and profit rates can have extremely perverse effects in an inflationary world where inflationary expectations are reflected in (nominal/real) interest rates. Uncertainty over future prices may make individuals and businesses extremely reluctant to enter into long-term contracts. Indexing offers relief from all these problems. Contracts, usury ceilings, and other agreements could be written in real rather than nominal terms, and arbitrary redistributions would be avoided because money payments would reflect actual not expected, inflation. At the same time there is concern that learning to live with inflation may make the economy more inflation prone.

BASIC EXERCISES

1. Wages, prices, and productivity. If all prices remain stable, all hourly labor costs may increase as fast as economy-wide productivity without, for that reason alone, changing the relative share of labor and non-labor incomes in total output. At the same time, each kind of income increases steadily in absolute amount. If hourly labor costs increase at a slower rate than productivity, the share of non-labor incomes will grow or prices will fall, or both. Conversely, if hourly labor costs increase more rapidly than productivity, the share of labor incomes in total product will increase or prices will rise, or both. It is this relationship among long-run economy-wide productivity, wages, and prices which makes the rate of productivity change an important benchmark for noninflationary wage and price behavior.¹

This exercise is designed to illustrate some of the ideas associated with wage-price guideposts based on increases in labor productivity. In particular, we will see that even if firms do not increase prices there can be increases in both wages and profits when wages increase in step with increases in labor productivity.

Column 1 of Table 17-1 illustrates the initial position of the Acme Manufacturing Company, a firm that produces gizmos. In all the remaining columns it is assumed that labor productivity has increased by 10 percent. (In reality, 10 percent would be an unusually large increase; we use it here to simplify the calculations. The same principle would apply even if the increase in labor productivity were smaller.)

- a. Column 2 assumes that hourly wages increase in step with labor productivity. Fill in the appropriate spaces for total output, total revenue,

- total wages, and profits plus overhead. What is the percentage increase in total wages and in profits plus overhead? Are they equal?
- b. Column 3 assumes that hourly wages increase by less than the increase in labor productivity. Fill in the appropriate spaces for total output, total revenue, total wages, and profits plus overhead. What is the percentage increase in total wages and in profits plus overhead? Are they equal? Are your answers to this and the preceding question consistent with the quotation from the report of the Council of Economic Advisers?
- c. Column 4 is meant to illustrate a situation of general inflation. As discussed in Chapter 17, the claim of wage-price guideposts is that wage increases equal to the increase in labor productivity plus the target rate of inflation will, in combination with price increases equal to the target rate, allow equal percentage increases in both wages and profits plus overhead. Prices and wages in column 4 are based on a target rate of inflation of 6 percent. Fill in the appropriate spaces for total output, total revenue, total wages, and profits plus overhead to see if the inflation plus productivity standard favors workers or capitalists.
- d. If things work so simply, why can't we eliminate inflation overnight by adopting an inflation target of zero?

2. This exercise is designed to illustrate the mechanics of indexing interest rates. Table 17-2 has data showing the market yield on one-year Treasury securities as of January in each of five recent years. For example, if in January 1976 you spent \$10,000 for a one-year Treasury security, in January 1977 you would have received \$10,544 (\$10,000 $\times$ 1.0544). This is a nominal return, that is, the interest rate reflects the number of dollars you will receive in one year, not how much you are getting when you will have.

¹ The Bureau Report of the Council of Economic Advisers, 1980, page 185.

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