Research Department
Federal Reserve
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Indexation: A Way Out?

"Indexation," as now defined, means essentially the raising of all **incomes** in proportion to the amount of **expenditure** inflation each year. This cannot be done in strict form: someone's income has to absorb the impact of fluctuating demand, and the main question thus comes down to who that someone is going to be.

Milton Friedman, the foremost academic proponent of indexation, cites these two basic elements:

- All wages would be adjusted in full for increases or decreases in the cost of living.
- Interest rates on deposits or debt would be adjusted in full for changes in the cost of living.

But Friedman would also add two other basic requirements for indexation.

- All index-linked contracts would have explicit legal status, although the writing of such contracts would be voluntary. Wage-linking is already becoming widespread, so Friedman believes that the principal effect of this change would be the creation of markets in index-linked bonds and other financial instruments on the Brazilian pattern. This view seems unassailable on the surface; even if there is only a small number of people desiring primarily inflation protection from their investments, the number of dollars involved would be substantial. Bonds of this type are not the same thing as the recently-popular variable-interest notes, which are tied to a market short-term rate, since market forces can push such rates into negative territory on a real basis. Also, variable-interest notes do not offer explicit protection of real capital; that is, they do not guarantee a reinvestment privilege for the inflation premium.
- The main current-dollar values in the tax structure would be linked to a price index, effectively eliminating fiscal "drag." This proposal, in keeping with the basic Friedman philosophy, would forestall the possibility of the income tax being used for influencing aggregate demand.

As Friedman has argued, indexation is fundamentally not an anti-inflation tool at all. It is, instead, a device to allow people to protect their incomes from the effects of inflation. It is therefore intrinsically neutral with respect to the actual rate of inflation. Lack of neutrality in the use of this technique comes about because of deliberate government action, primarily through the selection of the index to be applied.

Foreign experience

An example of selective use of indexation appeared in the British press recently. Almost all wages in the U.K. are at present index-linked under the "one pound plus" rule issued by the former Conservative government. When it became clear that the new Labor government wanted to do some reflating, **The Economist** suggested that it be done entirely by a cut in consumption taxes, because such taxes are the only ones fully reflected in the Consumer Price Index. The resulting

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fall in the CPI would keep the index from pushing up wages, and would thus lower the wage-cost pressure on business. This advice was valid in its analysis, but was not followed by the government.

A broader example is provided by the operation of the Brazilian "full indexation" process. Under Brazilian-style "monetary correction," almost all financial instruments and rents have received full inflation protection, and have thus enjoyed a positive rate of real return in the market. In contrast, wages are indexed against the official government projection of inflation for the following year. This projection has been deliberately set too low, so that real wages have remained well below productivity gains.

The resulting increment has been allocated partly to profits and partly to (indexed) transfer payments to the unemployed. The government consequently has been able to use indexing as a tool of deflation, no different in principle from a simple tax on wages with the proceeds going directly to business.

This use of indexing as a fairly dictatorial means of redistributing income has led many analysts to conclude that the technique cannot work in an anti-inflationary manner in a democratic state. However, the British example shows that the same end can be achieved through subtle means. But it also shows just how selective a policy tool indexation is, for in the example cited, indexing would be used to offset the inflationary effects of the proposed British reflation and thus force all of the initial effect into real-income growth. Such selective tools cannot really alter aggregate demand over time. Their impact rather is to reinforce certain desired effects of overall policy, or to allow the development of some desired institutional change.

Easing adjustment

The main point is **not** that indexation can be a cure-all for our inflationary ills, but instead that it can soften the necessary process of monetary and fiscal control, by making the burden of a squeeze much less arbitrary. Yet in practical terms, indexing also eliminates most of the arbitrary redistribution imposed by inflation, and thus lowers the public demand for its control.

We should also consider a slightly more subtle point—but perhaps a more crucial one in light of the recent fuel shortage. That is, what will happen if externally determined price increases actually lower the nation's standard of living? Under

full indexing, of course, everybody's income goes up, but output, if we are operating at capacity, cannot do so: prices must go up without end as they enter and re-enter the index. Thus, in certain circumstances indexing can be destabilizing. This point (although true) is not really very helpful, for it is simply not possible to generate a deceleration of inflation without imposing some slack on the economy.

Limited U.S. experience

The American experience is of little value in assessing the general issue, for the good reason that we have had almost no true indexation until very recently. Though wage cost-of-living escalators began with the Autoworkers' contracts of the 1950's, the early versions contained a low "cap"—a limit on the escalation—and provided an overall price elasticity in most wage contracts of less than 0.5. This type of escalator did not become very widespread, presumably because of its failure to provide large wage increases in the relatively weak inflation experienced before the late 1960's.

The first important breakthrough into full-scale indexing was not a wage indexation at all, but rather the indexation of military pensions in 1963. (This approach was highly unpopular with retired servicemen, for it replaced a system of adjustment tied to active-duty **wages,** which generally increased over time in real terms.) The next major indexation occurred only last year, when Congress formalized a previously informal system by CPI-indexing social security and related programs. This was followed by a breakthrough in the private sector in March of this year, when aluminum industry workers obtained essentially an uncapped wage escalator, along with a capped escalator for pensioners.

The trend is now growing rapidly. The Steelworkers union, following its success in aluminum industry negotiations, has moved to obtain the same benefits in the basic steel industry, and the Autoworkers—originators of the escalator—now have announced removal of the "cap" as a prime future objective. Major contracts negotiated in the first quarter of this year called for a 6.4-percent first-year wage increase, but those contracts yielded an 8.9-percent average increase after two quarters of escalation. If "capped" escalators—which could be considered equivalent to a Brazilian-style lid on real wage increases—were to be removed, further substantial wage gains could be expected in a continuing inflationary environment.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 9/04/74	Change from 8/28/74	Change from year ago Dollar	Change from year ago Percent
Loans (gross) adjusted and investments*	83,515	− 376	+8,145	+ 10.81
Loans gross adjusted—	66,218	− 375	+8,219	+ 14.17
Securities loans	1,110	− 645	− 23	+ 2.03
Commercial and industrial	23,656	+ 134	+3,325	+ 16.35
Real estate	19,805	− 14	+2,436	+ 14.02
Consumer instalment	9,479	+ 10	+ 703	+ 8.01
U.S. Treasury securities	4,406	− 39	− 893	− 16.85
Other Securities	12,891	+ 38	+ 819	+ 6.78
Deposits (less cash items)—total*	80,318	+ 353	+6,809	+ 9,26
Demand deposits adjusted	22,037	− 26	+ 543	+ 2.53
U.S. Government deposits	248	− 93	+ 2	+ 0.81
Time deposits—total*	56,126	− 78	+5,795	+ 11.51
Savings	17,709	+ 0	+ 104	+ 0.59
Other time I.P.C.	28,998	− 1	+5,293	+ 22.33
State and political subdivisions	5,986	+ 38	− 140	− 2.29
(Large negotiable CD's)	15,839	− 116	+3,675	+ 30.21

Weekly Averages of Daily Figures	Week ended 9/04/74	Week ended 8/28/74	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	113	23	85
Borrowings	448	352	225
Net free (+) / Net borrowed (−)	− 335	− 330	−140
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions Net purchases (+) / Net sales (−)	+1,125	+ 821	+1,804
Transactions: U.S. securities dealers Net loans (+) / Net borrowings (−)	+ 409	+ 581	+ 491

*Includes items not shown separately.

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