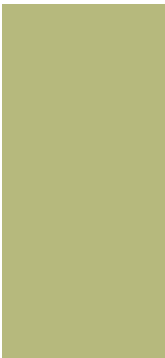


Wage Indexation, Inflation Inertia, and the Cost of Disinflation

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What are the consequences of wage negotiations on monetary policy in a country that is in transition to lower inflation? We show that wage indexation to expected inflation, increased central bank credibility and a higher frequency of wage adjustments can increase the effect of monetary policy and can decrease the cost of disinflation. Important welfare gains can be obtained with the best possible performance in the pursuit of inflation targets and with the highest possible precision in inflation forecasts since these actions increase central bank credibility. Wage policies like the one proposed by the Colombian Constitutional Court can have important negative consequences on output and real wages.

Keywords: wage indexation, disinflation, sacrifice ratio, staggered wage contracts, credibility.

JEL Classification: E1; E17; E52; E27; J30

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