

Ambiguity aversion and the absence of wage indexation

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Abstract

This paper analyzes optimal wage contracting assuming agents are not subjective expected utility maximizers but are, instead, *ambiguity* (or *uncertainty*) *averse* decision makers who maximize Choquet expected utility. We show that such agents will choose not to include *any* indexation coverage in their wage contracts even when inflation is uncertain, unless the perceived inflation uncertainty is high enough. Significantly, the exercise does not presume any exogenous costs (e.g., transactions costs) of including indexation links.

Key Words: Wage Contracts, Nominal Contracts, Indexation, Inflation, Uncertainty Aversion, Knightian Uncertainty, Choquet Expected Utility

JEL Classification: D81; J31

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We thank Berthold Herrendorf, Dennis Snower, Margaret Stevens, an anonymous referee and an Associate Editor for helpful suggestions and comments. Mukerji acknowledges financial support from an ESRC Research Fellowship Award. Part of this work was done while Tallon was at the Department of Applied Mathematics, Universita' Ca' Foscari di Venezia, Venezia, ITALY.

Running Headline: Ambiguity aversion and wage indexation