

HIGH & LOW FINANCE

Sometimes, Inflation Is Not Evil

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Andrew Harrer/Bloomberg News

Ken Rogoff, the Harvard economist, suggested central bankers consider “the option of trying to achieve some modest deleveraging through moderate inflation of, say, 4 to 6 percent for several years.”

Thirty years ago, it became clear that defeating inflation was crucial, even if the means needed to accomplish that would cause a deep [recession](#). By the time the European Central Bank was created in the 1990s, it seemed so obvious that inflation must be fought that the bank was given only one mandate — to fight inflation. The other mandate given to its United States counterpart, the Federal Reserve — to promote employment — was pointedly not included.

It is time for a new lesson to be learned. Sometimes we need inflation, and now is such a time.

Had the central bankers of the world understood that inflation in asset prices could be just as bad as, if not worse than, inflation in the prices of consumer goods, this would not be necessary. But they did not. So they did nothing to resist soaring home prices, just as they had seen no reason to worry about the Internet stock bubble.

When pressed, they would say they knew what to do if an asset bubble did burst — ease monetary policy. That seemed to work after the Internet bubble burst, and the ensuing

recession was a mild one that did little damage to anyone except foolish investors. But the strategy only worsened the housing bubble and has not done much to revive the debt-choked economy over the last two years.

In 2008, when the credit crisis brought the world economy to a screeching halt, governments and central banks stepped in to bail out large financial firms on the theory that a decently functioning financial system was a prerequisite to economic recovery.

That analysis was correct, but there were at least two problems with the fix:

First, at least some banks were not really made healthy again. That was especially true in Europe, where recapitalization of banks proceeded slowly. They were thus vulnerable to a new round of credit worries, this one based on sovereign debt issues.

Second, this country is full of people whose homes are worth less than they owe. That provides threats to the lenders and to the borrowers. Those borrowers need debt relief, but there are many issues that have prevented any real action.

Simply put, you can't operate an economy where huge numbers of people are desperately in debt and have no real way out. We need to either find a way to reduce what they owe or to raise the value of the homes securing the loans, or some of both.

In a [column in The Financial Times this week](#), Ken Rogoff, the Harvard economist, suggested central bankers consider “the option of trying to achieve some modest deleveraging through moderate inflation of, say, 4 to 6 percent for several years.”

Mr. Rogoff conceded that “any inflation above 2 percent may seem anathema to those who still remember the anti-inflation wars of the 1970s and 1980s.”

He was right about that.

“I don't think it's a good idea,” was one of the milder comments I got from the most celebrated veteran of those wars, Paul A. Volcker, the former Fed chairman.

And anyway, he added, “Right now they probably could not get inflation if they wanted to.” People are not spending the money they have, he said, adding that the situation reminded him of an era he studied in college — [the Great Depression](#).

In an interview, Mr. Rogoff recalled how a parade of economists suggested to Japan that it seek to raise inflation to an announced target after its bubble burst, how Japan did nothing

of the kind, and how it never really recovered. The Fed, he said, could make clear that it wanted some inflation and would buy Treasuries until it got that result.

“It has to be open-ended,” he said of such a program, not limited to a certain dollar amount of bond purchases, and it needs to be connected to a stated inflation target. The Fed chairman, he said, could say that “If and when inflation starts rising above the path I am aiming for, we will taper back bond purchases and raise interest rates to rein it back in.”

As it is, millions of mortgage loans secured by homes are worth far less than the loan amount. That keeps people from moving in search of better opportunities, and it removes an incentive for maintenance spending to preserve the value of the home. Many of those loans will never be paid in full, but there seems to be no route to a quick resolution.

To make things worse, we are still fighting about who should take the losses on those loans, and thus over who is in a position to offer a modification that reduces the amount owed. The banks that packaged the loans in private-label mortgage securitizations are being sued by the buyers of the securities and by insurers who foolishly guaranteed the securities. Fannie Mae and Freddie Mac are pursuing similar claims for mortgages they guaranteed.

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Moreover, state laws vary. In some states, mortgages are secured only by the value of the home, but in others the buyer is personally liable for paying even if the home's value plummets. In nonrecourse states, it would be easier to argue that banks should be willing to offer reductions in the amounts owed.

The Fed has pushed down interest rates to extremely low levels. That means people who have good credit, and homes worth more than they owe, can refinance and save money. But others cannot. One minor step that the president might be able to take without Congressional action would be to require Freddie and Fannie to offer to refinance mortgages they own or have guaranteed even if the collateral is no longer worth what is owed. That would at least pass on some savings to homeowners in distress.

Another idea tossed around has been to have the government force banks to offer principal reductions to underwater borrowers, perhaps in exchange for a portion of any eventual sales proceeds over the new mortgage amount.

Any such proposal runs into issues of fairness and huge difficulties deciding which borrowers would or would not be covered. Fears of moral hazard did not stop the government from assuring that lenders to overleveraged banks were paid back, but it may prevent any plan that would seem to help homeowners who took foolish risks. After all, is it fair to bail out someone who went in over his head while doing nothing for a neighbor who acted responsibly?

A partial way to deal with that would be to allow bankruptcy judges to reduce the amounts owed to market value. Since that would be available only to homeowners who filed for bankruptcy, it would not be available to those with other assets, and presumably the bank would be no worse off than if it foreclosed. But banks fought the idea and Congress refused to include it in the Dodd-Frank law. Mr. Volcker agrees that something needs to be done to reduce mortgage debt, although he points to a long list of obstacles, starting with moral hazard and including worries that banks do not have enough capital to admit how much they have lost. "But it is going to happen over a period of time," he said. "It would be a good thing if it could be facilitated."

The chaos that has engulfed financial markets, with new rumors of European bank failures, arose as it became apparent that recovery was unlikely until something was done to write down bad debts, whether American mortgages or Greek government loans, or to make them good again by raising asset values and thus increasing the ability to repay.

And yet the anti-inflation warriors continue to fight old battles. There were three dissents from regional Fed presidents when the Fed promised this week to hold down rates for at least two more years. The European Central Bank has been raising rates on the belief that it must vigorously fight any sign of inflation.

In the future, central banks will have to realize that debt-financed expansions in asset prices can be a threat. For now, it would be nice if they would at least recognize that major deflations in asset prices can be much more important than the relatively small gains in commodities that show up in the [Consumer Price Index](#).