Some Monetary Officials Contemplate Higher Inflation

Saturday’s New York Times ran a thoughtful piece that should send a shudder through any holder of long term bonds. While maintaining low inflation is typically in the DNA of every good central banker, some are starting to question the orthodoxy of a relatively inflexible approach to changes in the price level. While high inflation (10%+) is widely (and no doubt correctly) believed to be highly damaging, there is support for the notion that inflation above 2% (the Fed’s target) can ease price adjustments. This is because while few workers will willingly accept a cut in pay, 5% inflation with a 1% pay hike results in the same 4% loss in REAL earnings as a 2% cut with 2% inflation. In other words, a little bit of inflation allows companies to increase profit margins as long as their revenues keep better pace with inflation than their costs.

Presumptive Fed Chairman Janet Yellen has argued for the benefits of temporarily higher inflation, and many academics including some quoted in the NYTimes article have argued the same. It’s a logical extension of the strategy of financial repression currently being pursued. Interest rates that are equal to or below inflation are a fairly painless way to reduce the inflation-adjusted value of debt, and in the U.S. we have $36 trillion of debt if you add all levels of government, households and students as I showed in my book, *Bonds are Not Forever; The Crisis Facing Fixed Income Investors.*

It illustrates the shifting winds; because debt is so ubiquitous, minimizing its cost to borrowers is more important than appropriately compensating those who fund it. So far it’s sound public policy. But clearly holders of long term bonds yielding close to current inflation rates are scarcely being compensated for the risk that a drift up to 3-4% inflation may turn out to be a quite acceptable monetary policy outcome.