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Some Economic Implications of the Indexing of Financial Assets with Special Reference to Mortgages

[Franco Modigliani](#)

Chapter

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Abstract

As long as loan contracts are expressed in conventional nominal terms, a high and variable rate of inflation — or more precisely a significant degree of uncertainty about the future of the price level — can play havoc with financial markets and interfere seriously with the efficient allocation of the flow of saving and the stock of capital. Indeed it may be argued that this is one of the most damaging unfavourable implications of unpredictable inflation rates, potentially as serious as the capricious redistribution of income and wealth which, in the popular view, is the

hallmark of a disorderly inflationary process. It has been suggested by many economists for quite some time now that these unfavourable effects on resource allocation as well as the redistributive effects can be eliminated or at least greatly alleviated by the device of 'indexing' financial contracts, especially long-term contracts.

Indexation consists in denominating the principal and the interest in 'real terms', i.e. in terms of 'a suitable commodity basket'. In practice, this means that the nominal value of the principal is revalued periodically on the basis of an index of the changing nominal value of the stated basket, and that the agreed interest is to be applied to the revalued principal.

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