BUSINESS CASE STUDY

Effects of inflation on commercial banks

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Inflation is the general increase in prices and corresponding fall in value of money. There are several causes for inflation. It might be a result of having too much money injected in the market either by the government through a purchase of bonds, or from the commercial banks issuing loans. Another cause may be a considerable increase in the aggregate demand for money in the market, while the aggregate supply is lagging. Moreover, there are situations when the firm faces an increase in input costs (such as raw material, wages, utility etc.) and this is passed on to the customer by increasing output prices. The resulting inflation invariably affects commercial banks, as can be exemplified by the case of the Arab Bank.

The Arab Bank is a Jordanian bank that operates in several countries. If one of the countries in which it operates suffers from inflation, the government might force all institutions to raise their employees' salaries to compensate for the increases in prices. As the bank raises its salaries, its overhead costs increase, putting a downwards pressure on profits. Therefore, in order to compensate for this increase in cost, the bank has to find a way to increase revenue, which can be done by increasing transaction fees, the interest rates it charges for loans, or the exchange rate margin.

Receiving deposits is one of the main activities of a commercial bank. Depositors receive a certain interest rate for the use of their money, while the bank offers deposited funds on the interbank exchange and receives a corresponding "borrowing rate". Both rates are nominal rates, which take inflation into consideration; thus the real return is the difference between the nominal rate and the rate of inflation. Therefore, if any country in which the Arab Bank operates suffers from inflation, the bank will suffer from lower real return. Moreover, the Arab Bank will have to increase interest rates for customers who deposited a large amount of funds in order to ‘lock them in’ and avoid the outflow of these deposits to another bank: the ‘spread’ between the interest they give to the creditors and the interest they receive from the borrowers will further decrease, which can be exemplified as the following.

If the Arab Bank has extended a loan for two years at 8% and has a corresponding deposit at 4% to cover it for 3 months only, it earns a profit in the form of a “spread” of 4%. If the inflation occurs in the short term, the bank has to increase its deposit rates to continue attracting depositors. Each 1% increase in deposit interest rate will directly impact the bank’s profit. For example, if the 3 month rate becomes 5%, the net margin (spread) will decrease to 3%.
Since inflation leads to an increase in the overall price level, the goods and services become more expensive in nominal local currency. Therefore, if the exchange rates don’t adjust immediately, an importer of these goods and services would have to pay more units of the foreign currency to acquire them, so country’s exports can be damaged significantly as a result of inflation. As a response, the Central Bank of the country under inflationary pressures will have to depreciate the domestic currency to counter the effects the overall increase in prices. This will make the foreign currency more expensive for the local buyers, which may lead to the bank’s customers demanding less currency exchange services. Since the bank earns a certain margin on currency exchange services, inflation will lead to a decrease in Arab Bank’s revenues.
Finally, inflation decreases the value of money, as we have to pay a greater amount of money for the same good or service. One of the reasons a bank imposes a certain lending rate on its loans is to counter the anticipated inflation effects. However, if a 30 year loan is extended at 8% while the inflation rate is at 4%, the real return for the bank will be the difference between the nominal and the real interest rate: 4%. So if the inflation increases to 6%, then the real return would decrease to 2%, so the real profit from the bank’s lending operations will be hampered.

Sources:

http://classroom.synonym.com/relationship-between-inflation-bank-interest-rates-14807.html

Bank Management & Financial Services, McGraw-Hill 9th Edition and the class of Finance 225: Commercial Bank Management.