Finance, Economics and Applied Research Journal
Vol. 2, No. 2, April 2015, pp. 1 - 6
Available online at http://fearj.com/

Research article

Correcting The Missing Puzzle: How Inflation Benefit Banks and Governments

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Abstract

Many studies have found significant negative correlation between inflation and growth with many conclusions affirming that higher inflation and greater inflation volatility slows down economic growth. This paper employed content analysis based on literature reviewed from secondary sources to make a unique contrition by highlighting how major economic players in the likes governments and banks benefit from inflation.

Keywords: Inflation, Economic growth, Economic benefits, Banks, Government

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1.0 Introduction

Actual records show that during the seventies, both developed and developing economies suffered from high and unstable inflation. During the 1980s, industrialized nations were able to bring down inflation and had it under a reasonable level of control. Developing economies on the other hand were severely afflicted with high inflation. In the 1990s, consequence of numerous economic reforms such as privatization of hitherto ill-efficiently managed SOEs, inflationary pressures were eased which brought about reduction in fiscal deficits of most governments. Today, inflation targeting or achieving lower or stable inflation has become a top priority of monetary authorities of most economies, irrespective of development status.

Loungani and Swagel (2001) observed that the main sources of inflation in developing economies are output gaps and a measure of the world's business cycle, money growth and exchange rate volatility. Contributions of Loungani and Swagel are note-worthy contributions in as much as its weakened by the fact that their contributions failed to capture other important factors such as underlying institutional and political features which can fuel inflation or provide such conducive atmosphere for inflation to prevail.

But whatever had been said of inflation, there is no doubt it is a feared subject and it is important to highlight why it is feared. *"Uncertainty"*. Uncertainty is the biggest harm from inflation. Golob (1994) conveyed that, if inflation is fully anticipated, individuals (businesses and consumers) will plan their activities on the accurately predicted rate of inflation and adjust their contracts for labor and debt accordingly. However, inflation is not fully anticipated. Investors must make guesses at how much future inflation is going to be and set interest rates and exchange rates accordingly. This is often less difficult when inflation rate is low, but it becomes more difficult when inflation is high. The reason is that low inflation tends to be stable and hence fairly predictable. But as inflation becomes higher, it tends to become more volatile and hence less predictable. High levels of inflation and high volatility in the level of inflation affect adversely the allocation of capital necessary for economic growth.

On the other hand, during times of inflation where the purchasing power of money becomes eroded, households and businesses would rather hold little or no reserves and instead, keep such reserves in interest bearing or profit generating accounts. This remains a sane and rational thing to do because interest and or profits earned would at least offset the missing part of money eroded by inflation. This behavior tends to improve the number of transactions for banks. Hence, the higher the number of transactions for banks, the more profitable they become. On the other hand, since inflation is always and everywhere a monetary phenomenon, governments' monetary authorities charged with the responsibility of printing money does so to aid the government in its spending plans. When excess of printed money circulate the economy, it brings about inflation which not only distorts markets but levies inflation tax on households and businesses making governments to gain. Similarly, with fixed interest on government bonds and other securities, the governments' obligation as a debtor is worth less at end of an inflationary period than it was at the beginning. In other words, inflation has a way of transferring wealth to debtors (of which the government is usually the largest) from creditors.

Following this introduction, section II of the paper provides a brief insight into inflation. Sections III, IV and V offer a theoretical insight into why inflation is bad and how the banking sector and governments are affected by inflation respectively. The last part of the paper gives a conclusion.

1.1 Conceptualizing Inflation

The term inflation is widely used when economic discussions are made, yet there is little understanding of the subject among people. Milton Friedman says inflation is always and everywhere a monetary phenomenon. Makinen, (2003) thought inflation to be a sustained rise in general prices of goods or services. The position of Makinen on the subject isn't dissimilar to that of Hazlitt (1964) who sees inflation to be a decline or fall in the value of money. Bach and Stephenson (1974) contend that inflation is a state where there is plenty of money in circulation, chasing fewer services and goods within an economy. To sum the positions of these authorities, inflation erodes the value of money. A hypothetical case is to assume N100 is able to buy 100 bottles of coke today. Assuming the price of coke doubles in the next period, N100 would afford only 50 units of the same product. Or if inflation is rated at 2% at the beginning of a period, assuming this rate doubles towards the end of a period due to either money growth or exchange rate volatility, it means the prices of services and goods would be up by 2% and people would need to up their spending by 2% more to be able to purchase the same services and goods they hitherto would have been able to afford earlier.

1.2 Why inflation is Bad

The biggest problem and harm from inflation is uncertainty. Inflation creates uncertainty about future inflation, as such, decision making for businesses and individuals become inefficient which often leads to reduction of the economic well-being of those affected. Put in other words, if future inflation were to be fairly certain, businesses and individuals would be able to plan for the future with some sense of efficiency. This is because if inflation is fully anticipated, individuals will plan their activities on the accurately predicted rate of inflation and adjust their contracts for labor, debt and other activities accordingly. However, inflation is not fully anticipated. Investors merely take a guess at how much future inflation is going to be and set interest and exchange rates accordingly. A striking thing to note here is that, making this guess work is less difficult when the rate of inflation is low, but it becomes a lot more difficult when inflation is high. The reason is that, low inflation tends to be relatively stable and hence fairly predictable. On the other hand, if inflation becomes higher, it tends to become more volatile and hence less predictable. When this happens, decision making and allocation of resources are clouded by inefficiencies leading to market failure.

Similarly, when there is no certainty about future inflation, optimal allocation of capital in the capital market is affected. For instance, if there is uncertainty about the real interest rates and investors are left with option of guessing, there is a greater possibility that investors would demand higher return rates; and when rates of are high, crowding effect crowds out investments in the economy because borrowers who would in turn invest would be discouraged from borrowing due to high cost of borrowing. In same vein, it is vital to also remember that inflation in its self imposes a certain tax known as inflation-tax on individuals who hold money reserves.

1.3 How The Banking Sector is affected by Inflation

Boyd and Champ (2006) offered a typical example of how inflation affects economic growth through the banking sector. Boyd and Champ observed that, with high inflation, there tends to be an overall reduction in the amount of money or credit lent to businesses. In other words, as inflation increases, real rate of returns on financial assets become less. If this were the case, then real rate of returns on financial assets will tend to be low. When such rates are low, the surplus sector of the economy will have no motivation to save; as such, saving culture within the economy is affected adversely. On the other hand, the deficit or borrowing sector of the economy will be encouraged to borrow because it is cheap to do so. The problem with this as asserted Meltzer (1992) is that more risky, non-credit worthy and less quality borrowers are encouraged to flood the money market, aftermath of which is the possibility of default. But how do banks handle a situation of this sort? Ghosh et. al., (1999) offered what is almost certainly the right answer. Ghosh et al., (1999) convened that when the money market is flooded with less quality and high risk borrowers because it is cheap to borrow, banks resort to credit rationing; a term used to describe situations whereby banks find it difficult to differentiate between bad or good borrowers and decide to restrict or limit credit supply to borrowers even if they (borrowers) are willing and ready to pay higher rates. The effect is that, when credit is rationed, the rate of investment will fall because investors find it hard to borrow. This lowers economic productivity; and when economic productivity gets low, real economic activities are affected negatively. This will bring about market failure, adding to a list of examples of market imperfection.

On the other hand, it is vitally important to point out that; inflation affect different groups in dissimilar manner. Banking businesses can actually be more profitable in event of inflation as would be discussed in a mean time.

Agreed that, inflation is bad for individuals and enterprises largely because of the uncertainty that comes with it; but inflation may actually be good for banks. Banks in developing economies have often benefited from inflation. Foremost, inflation increases the velocity of money and the number of monetary transactions. When we talk of velocity of money, we are referring to the velocity of money circulation or the frequency with which one unit of currency changes hands over a given period of time. When the value of currency deteriorates due to inflation, individuals and firms want to get rid of their reserves more quickly in order to avoid the effect of inflation-tax taking toll. This means, people would rather have their reserves in interest bearing accounts banking on the possibility that the returns on their saving would atleast off-set the value which inflation would normally erode. This increases the number of transactions conducted through banks and therefore the volume and profit of bank business goes up. Similarly, as the velocity of money (Velocity: the rate at which money changes hands per time) increases leading subsequently to increase in number of bank transactions and money passes from one bank account to the other. In other words, money floats. Float is a term used in economics to describe money which is present at the bank which has been deducted from a sender's account but has not been paid to the recipient of the money. Float is owned by the banking sector for a period of time to mature, the time depends on the nature of transaction which could range from hour(s) to days. While such money is transiting from one bank account to another, banks do not pay any interest on such money. Money that floats from one bank account to another increases when inflation is high because people do not want to hold money reserves; and because banks do not pay interest on the float, it becomes an interest free source of funding for banks. A sizeable proportion of this float may be shared with the central banks where the commercial banks hold non-interest bearing accounts with the central bank. Thus, it often happens that the banking sector appears to do quite well during periods of inflation. In fact, it can be argued that banking may be the most profitable business venture in economies suffering from hyperinflation.

1.4 How Government Gains from Inflation

It is a clear that inflation reduces the real value of money and non interest bearing deposits. It means there is a missing value. Question is; who gets the missing value? Monetary authorities of course. Money reserves are the obligation of the issuing government. It happens that, at the end of an inflationary period, the obligations of the government are worthless than at the beginning of the period because government as a debtor benefits at the expense of households who happen to be government's principal creditor. For instance; government bonds and other securities whose interest rates are fixed as at when traded; investors who ventured into such securities would yield little or no returns on their investments due to eroding effect of inflation. Inflation therefore can be seen as a tax on money holders (households) of which is the gain of the government. Thus, inflation isn't only an outcome of budget deficit; it is also a solution to budget deficits especially if it happens that the revenue generating capacity of the government from conventional taxes isn't much. This presents a very convenient form of taxation that is almost costless and causes little or no political resistance as compared to explicit form of taxation.

1.5 Conclusion

There is no doubt inflation has tendencies of discouraging long term planning and investment or bringing about inefficiency in the allocation of scarce economic resources which can have a distorting effect on the economy. However, it is important to assert that inflation affect different people or groups differently. Those with flexible income will certainly gain at the expense of their peers on fixed incomes.

This paper has shown that uncertainty is the greatest harm that comes with inflation because households and businesses would hardly plan or adjust their contracts for labor and debts on the accurately predicted rate of inflation; as such the economy would be adversely affected due to inefficient decision making. However, the paper made a unique contribution by fixing the missing puzzle and correcting a common weakness as observed in many studies who entirely depict the negative side of inflation. This paper has shown that banks tend to be the most profitable business to venture especially in times of hyperinflation. Similarly, the government as a debtor gain at the expense of households who happen to be its principal creditors; even as much as inflation-financing can be employed by the government to raise taxes that are costless and without any political resistance to offset budget deficits which would ordinarily would have been hard to do with explicit form of taxation.

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