FINANCIAL PERSPECTIVES

Does Inflation Favor Lenders or Borrowers?

December 15, 2020

Data by:
By TROY SEGAL for
Investopedia

Many economists agree that the long-term effects of inflation depend on the money supply. In other words, the money supply has a direct, proportional relationship with price levels in the long-term. Thus, if the currency in circulation increases, there is a proportional increase in the price of goods and services.

Aside from printing new money, there are various other factors that can increase the amount of currency in circulation. Interest rates may be reduced, the reserve ratio for banks may be reduced (the percentage of deposits the bank keeps in cash reserves), there may be increased confidence in the banking system, or a Central Bank may buy government securities or corporate bonds (resulting in people who were holding the bonds having more money to spend), among other factors that may increase the money supply.

Inflation occurs when there is a general increase in the price of goods and services and a fall in purchasing power. Purchasing power is the value of a currency expressed in terms of the number of goods and services that one unit of the currency can purchase.

For example, imagine that tomorrow, every single person's bank account and their salary doubled. Initially, we might feel twice as rich as we were before, but the prices of goods and services would quickly rise to catch up to this new wage rate. Before long, inflation would cause the real value of our money to return to its previous levels. Thus, increasing the supply of money increases the price levels. ***Inflation can benefit either the lender or the borrower, depending on the circumstances.***

KEY TAKEAWAYS

The money supply has a direct, proportional relationship with price levels; If the currency in circulation increases, there is a proportional increase in the price of goods.

- Inflation occurs when there is a general increase in the price of goods and services and a fall in the purchasing value of money; it can benefit both borrowers and lenders depending on the circumstances.
- Inflation allows borrowers to pay lenders back with money that is worth less than it was when it was originally borrowed, which benefits borrowers.
- When inflation causes higher prices, the demand for credit increases, which benefits lenders.

Inflation Can Help Borrowers

If wages increase with inflation, and if the borrower already owed money before the inflation occurred, the inflation benefits the borrower. This is because the borrower still owes the same amount of money, but now they more money in their paycheck to pay off the debt.

When a business borrows money, the cash it receives now will be paid back with cash it earns later. A basic rule of inflation is that it causes the value of a currency to decline over time. In other words, cash now is worth more than cash in the future. Thus, inflation lets debtors pay lenders back with money that is worth less than it was when they originally borrowed it.

However, it assumes an inflation rate. The Consumer Price Index, which is likely the best tool for estimating inflation, has only touched 3% once in the last several years and is usually around 1.5 to 2%. Some people debate whether CPI is a good measure of inflation and some argue for other rates, but CPI is a pretty solid benchmark for inflation.

Inflation does vary over time, but we're currently in a period of very low inflation. Most inflation-based arguments rely on an inflation rate of at least 3% for people to make financial moves based on the inflation rate.

Do mortgages adjust for inflation?

Or, perhaps you're more concerned with the more pertinent question — do mortgages increase with inflation? It depends on the type of mortgage loan. Those with fixed-rate mortgages won't be negatively impacted by higher inflation as the interest rates are locked in, as the name implies. Fixed-rate mortgage holders may even benefit from increased inflation since they are paying back money at a much lower value than it was borrowed at. Variable-rate mortgages, on the other hand, have interest rates that increase or decrease with economic fluctuations, which leaves borrowers with variable interest rates and payments.

If you're in a position where inflation is at 5% and savings accounts are paying a 6% return, it makes a lot of sense to put money into a savings account and make minimum payments on a 3.75% mortgage. On the other hand, when we're in the position we're at now, with savings accounts paying 1% and inflation somewhere around 2%, you're going to want different solutions. Just because you choose to make early payments now doesn't mean you can't choose to do something differently later on.

Key takeaways

- Ideally, the longer you're in the workforce, the more raises you're likely to receive at the rate of inflation (or better) — and thus the less percentage of your paycheck your mortgage will take up.
- However, don't assume that will be the case, as annual raises are not reality for most people. In many industries, wage increases aren't keeping up with inflation and many people don't have the means to make a sizable investment to get a large return.
- While inflation rates do fluctuate, they rarely reach 3%. Rates are sitting at 1.4% as of September 2020.

Inflation Can Also Help Lenders

Inflation can help lenders in several ways, especially when it comes to extending new financing. First, higher prices mean that more people want credit to buy big-ticket items, especially if their wages have not increased–this equates to new customers for the lenders. On top of this, the higher prices of those items earn the lender more interest. For example, if the price of a television increases from $1,500 to $1,600 due to inflation, the lender makes more money because 10% interest on $1,600 is more than 10% interest on $1,500. Plus, the extra $100 and all the extra interest might take more time to pay off, meaning even more profit for the lender.

Second, if prices increase, so does the cost of living. If people are spending more money to live, they have less money to satisfy their obligations (assuming their earnings haven't increased). This benefits lenders because people need more time to pay off their previous debts, allowing the lender to collect interest for a longer period. However, the situation could backfire if it results in higher default rates. Default is the failure to repay a debt including interest or principal on a loan. When the cost of living rises, people may be forced to spend more of their wages on nondiscretionary spending, such as rent, mortgage, and utilities. This will leave less of their money for paying off debts and borrowers may be more likely to default on their obligations.

The FMA ADVISOR is published periodically for the exclusive use by clients and associates of Financial Management Associates, LLC. The information herein was obtained from sources that we believe are reliable, but we do not guarantee its accuracy. Neither the information, nor any opinion expressed, constitutes a solicitation of the purchase or sale of any securities, commodities, or funds. Please note that past performance is no guarantee of future results.