

Essay: “Assume five years from now the developed world is faced with very high levels of inflation. Discuss the impact on and strategies for a Bulgarian Bank to protect their assets and operations.”

“Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man.”
Ronald Reagan

Introduction

Armed with Reagan’s adage, and monetarist ideas, this essay will explore a few ways in which a Bulgarian bank can effectively cope with the specter of inflation. At its most basic level inflation is a rise in consumer prices, effectively making goods and services more expensive in the reference home currency. It can be driven either by supply or demand shocks, or more fundamentally, it can signal the economy nearing its potential (or even surpassing it).

Inflation will eventually lead to twofold results. First, if Eurozone inflation overtakes Bulgaria’s, the lev will appreciate in real terms, with all its consequences. Second, an activist European Central Bank will probably eagerly jump to fight it through open market operations, interest rates or any other ruthless means necessary. All those result in an increase of interest rates, thus suppressing investment and slowing down economic activity. Given this situation, a Bulgarian bank* needs to carefully manage its assets and liabilities in order to continuously create value for its shareholders.

Managing Assets

In terms of portfolio investments, the bank will be wise to avoid investing in stock, and switch much more to fixed-income securities. Suppressed business activity will lead to a plunge in stock prices, and so the stock exchange market is not the place to look for either return or security. Furthermore, the bank might want to take extensive use of TIPS bonds – i.e. bonds indexed with inflation. Although their return is not as high as that of regular ones, during turbulent times they will preserve value.

A truism for managing FOREX exposure is to decrease exposure in foreign currencies, likely to lose value and switch to more stable currencies. Alternatively, the bank can obtain a futures contract in some investment good, thus ensuring that value is preserved through time despite the money’s depreciation. For example, it will purchase a given quantity of gold or oil for a given price, thus already factoring a certain rate of inflation in its operations.

Credits comprise not only the core of the bank’s business but also its main asset in terms of value. In the perilous situation described, the price of external financing is not only fluctuating but rising significantly. To shield against these developments, credit interest rates will have to be structured so that they include a flexible component. The institution may for example include either the LIBOR or EURIBOR as an interest rate component, and then add it to

* Although this essay will not mention any names explicitly, the underlying assumptions conform to the setup of Bulgaria’s five largest banks: good capital adequacy and liquidity, relatively high ROA, and being a part of an international financial group.

the base interest rate and the specific risk premium for the given customer. In addition to that credit standards should be increased and projects be much more carefully scrutinized. Inflation in Bulgaria and in the EU means slower growth, decreased reliance on exports, and weak business activity. Returns in such environment can be extremely tenuous and the bank should allocate its resources accordingly.

Managing Liabilities

A highly inflationary market may lead investors to the need to liquidate and reinvest assets, and some financial institutions might want to withdraw their financing. Additional demands on liquidity are put by depositors withdrawing their money. The bank's main goal in respect to liabilities needs to be an overarching focus on maintaining both a capital adequacy and liquidity above regulatory standards, and preserving credibility.

An effective business strategy might be to use the problem as an opportunity and try to capture a larger market share by offering extremely competitive but essentially short-lived deposit offers. This strategy has seemed to work remarkably well in the last couple of years in Bulgaria.

Conclusion

As a concluding remark I cannot help but quote M. Friedman that inflation is taxation without legislation, meaning that it effectively shuffles wealth away from creditors to debtors. Irrespective of the bank's exposition, it should keep in mind that like pretty much everything, the inflationary problem is as much a threat as it is an opportunity.