MOORE

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INFLATION AND CREDIT UNIONS

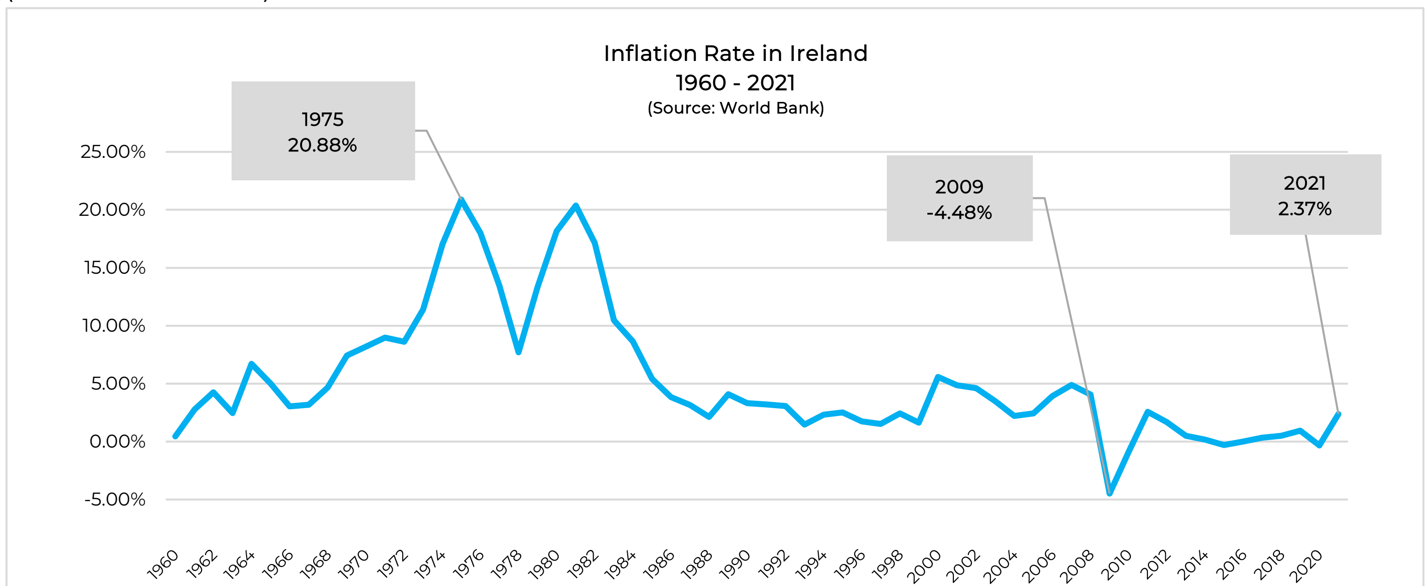
A perspective from internal audit

Introduction

“Inflation is just like alcoholism....the good effects come first; the bad effects only come later”. Famous words from the famous Nobel Laureate economist, Milton Friedman. As we grapple with the prospect of inflationary pressures, the immediate impulse for an Irish credit union may be one of relief, due to the prospect of investment yields increasing. We are transitioning from a prolonged period of low interest rates to a period of increasing interest rates driven by inflationary pressures. But are there longer term risks we need to consider? Is there a Friedman style hangover looming around the corner, and if so, what may that hangover look like? As a firm of internal auditors, we felt it might be helpful to reflect on inflation and look to provide some insights in the lead up to the internal audit planning process later in the summer of 2022.

What is inflation?

Inflation occurs if there is a broad increase in the prices of goods and services, not just of individual items. It means, you can buy less for €1 today than you could yesterday. Inflation reduces the purchasing power of money, and in this regard, inflation ultimately devalues a currency. Inflation can happen in “rounds”. Currently, there is an expectation that a second round of inflation will occur. This describes a situation where high inflation feeds into higher wages, implying increased costs for businesses, which then leads to higher inflation again. Inflation therefore, can cause more inflation. Inflation accelerating out of control, hyperinflation, can be highly destructive to society and lead to drastic social and political outcomes. The classic example is the fate of the mark in the German Weimar Republic following World War I. Dr Schacht, the then Currency Commissioner of Germany, explained that at the end of World War I one could in theory have bought 500,000,000,00 eggs for the same price as that for which five years later, one single egg was procurable. At its nadir, a cup of coffee would cost 5,000 marks when ordered, and 8,000 by the time it was drunk. Weimar hyperinflation was the “most powerful engine of upheaval” [1]. Hence, controlling inflation is a key political imperative. Today, the primary objective of the ECB is to maintain price stability and preserve the purchasing power of the Euro. The general quantitative target of the ECB is 2% inflation. Currently, inflation in Ireland is projected to be 6.5% in 2022[2]. Contrast this to 1975 (inflation of 20.88%) and 2009 (deflation of -4.48%) as illustrated below.



[1] This quote comes from “When Money Dies”, Adam Fergusson (1975) which is the classic account of the German hyperinflation experience in the 1920s.

[2] Central Bank of Ireland, Quarterly Bulletin Q2, 2022

What has caused the current elevated inflation?

The general thinking is that there are currently four key drivers of the elevated inflation position in Ireland: the re-opening of the economy after the pandemic restrictions, supply-chain disruptions, the impact of the Russia-Ukraine war, and high increases in energy costs[3]. On a broader level, Christine Lagarde, President of the ECB, commented in June 2022[4] "looking at inflation, it has risen further, standing at 8.1% in May. Energy prices stand 39.2% above their levels one year ago. Food prices rose 7.5% in May, in part reflecting the importance of Ukraine and Russia among the main global producers of agricultural goods. Prices have also gone up more strongly because of renewed supply bottlenecks amid recovering domestic demand, especially in the services sector, as our economy reopens".

What is the policy response to inflation?

The general policy response from Central Banks is one of swift and decisive action. Our very own Philip Lane (former Governor of the Central Bank of Ireland, now member of the Executive Board of the ECB) in a recent speech in London[5] stated that the ECB "stand ready to adjust all of our instruments within our mandate, incorporating flexibility if warranted, to ensure that inflation stabilises at our two per cent target over the medium term". The primary instruments that Philip Lane refers to are firstly, asset purchases (the technical term for what is more colloquially known as "quantitative easing"), and secondly, interest rates. The stated policy of the ECB is to end quantitative easing immediately and to increase interest rates. On the matter of interest rates, ECB President Christine Lagarde indicated "a gradual but sustained" path in interest rate increases is appropriate. In this regard, the past decade which has been a period of "loose monetary policy" characterised by quantitative easing and low interest rates, is changing to a period of "tightening monetary policy", characterised by an ending of quantitative easing and rising interest rates. Collectively, this process is being referred to as "monetary policy normalisation", suggesting that we are moving from a period of abnormal policies (quantitative easing and low interest rates) to something that looks more normal (no more quantitative easing and higher interest rates).

How do increased interest rates lower inflation?

Inflation results from aggregate demand exceeding supply, i.e. an imbalance between demand and supply. Increasing the cost of money reduces purchasing power. By increasing interest rates, the ECB is trying to slow down spending in the Eurozone, and thereby reduce demand. This in turn corrects the imbalance by reducing demand, and therefore reducing inflation. There are risks with this: if interest rates remain high enough for long enough, economic growth could slow down. Or, as inflation decreases following monetary policy intervention, economic growth slows down. In this scenario, spiralling inflation ends, but a recession may start. Turning to another Noble Laureate, Joseph Stiglitz recently noted that[6] "any honest account of inflation must carry a big disclaimer: Because we haven't been through something like this before, we can't be sure of how things will evolve". Some of the conditions that have led to inflation (as set out earlier) are unique, such as a pandemic and a war.

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[3] For more see: Central Bank publishes Economic Letters analysing inflation developments and expectations

[4] At the European Parliament Hearing of the Committee on Economic and Monetary Affairs of the European Parliament (europa.eu)

[5] Society of Professional Economists Annual Dinner, London, June 2022

[6] 7 February 2022 https://www.project-syndicate.org/commentary/inflation-causes-and-targeted-solutions-by-joseph-e-stiglitz-2022-02

What does this mean for credit unions?

Predicting the future is always a dangerous pursuit, but with Friedman's alcoholism metaphor in one hand, and, Occam's razor in the other, a reasonable series of outcomes may be expressed as follows:

- It is likely that **investment yields** will increase, bringing an increase in investment income. In this regard, investment opportunities are likely to present themselves over the coming months which will require robust investment governance frameworks to operate effectively. Overall though, this is a good thing. Let's call this the positive effects of alcohol that Friedman refers to.
- With an increase in investment income, will come the matter of **dividend policy** and the wider matter of the level of return on members' savings. Within this, lies a new challenge. A striking feature of the Irish credit union system when compared to the more mature credit union systems of USA, Canada and Australia, is the lack of diversity in savings products. The vast bulk of savings in Ireland are demand based shares which attract discretionary annual dividends. In the USA, Canada and Australia, a range of interest bearing savings products are offered to members. This brings versatility and adaptability. Assuming interest rates are going to increase in a sustained manner (and Christine Lagarde's words resonate in our ears), a key challenge for credit unions will be how to diversify savings to ensure competitiveness in savings products. We may very well be about to witness a shift from standard share accounts to a range of deposit based products, offering more competitive rates. This, in turn, may complement credit union strategies on house and business lending. If credit unions can develop a range of term based deposit products, this will build a more stable funding platform to support longer term lending profiles (classic asset liability management strategies). However, diversifying savings products is not something that will happen overnight, nor will it be straightforward. Strategic planning and risk management frameworks will need to assess this in earnest, and, carefully consider the way forward.
- It is likely that **borrower repayment capacity** will, in time, become impacted, if increases in consumer prices outpace increases in household earnings, leading to credit union loan loss provision increases. This is most certainly the Friedman hangover. In this regard, provisioning and arrears management frameworks will become more in perspective as the inflation cycle progresses. A bleaker outcome would present itself, if, in addition to consumer prices outpacing income, either prolonged inflation or the consequent deflation leads to a slowdown in wider economic growth, and, a recession. Let us not forget, in the middle of the last recession, A1 arrears grew to over 20%. Currently arrears are under 4%.
- It is likely that the second round inflationary effect will kick in at some point later in the year, and, credit unions will notice an increase in **overheads**. Over the past decade, cost budgeting has been a very formulaic matter, with cost bases remaining relatively static or moving by small increments. This looks set to change, and in an era of compressed margins, cost inflation will not go unnoticed.

Naturally, the sequencing of these contrasting economic outcomes is hugely relevant. It is possible that credit unions will experience an increase in investment income before the longer term impacts of an inflationary environment become more apparent (loan losses, increases in cost of funds and overheads, etc.). In this regard, prudence is key. In the natural order of things, the bad effects of alcohol follow the good effects.

Internal audit planning

The primary goal of this article is to stimulate discussion in the lead up to the internal audit planning process for FY2023, as inflation has altered the economic playing pitch of credit unions. The more obvious audit themes that emerge in an inflationary environment would appear to be **provisioning**, **arrears management** (particularly for home loans with more demanding consumer protection standards) and **investment governance**.

However, the overwhelming point we would make, relates to **financial projections**. Financial projections are based on economic assumptions, many of which will now look very different. It is most certainly time to dust off the financial projections (yet again) and create new scenarios. What happens if investment yields increase? What happens if loan losses increase? What happens if overheads and/or labour costs increase? What happens if a cost of funds (dividend, interest) is factored into the equation? More importantly, when do we expect these changes to happen, in a multi-annual context? And crucially, what do various combinations of the aforementioned assumption changes do to capital and liquidity levels? Financial projections are not intended to be an exercise in predicting the future. Financial projections are intended to provide an understanding of the future financial impact of current decisions. Credit unions will face a number of "big" decisions as the inflationary environment progresses, particularly in the realm of savings management (e.g. savings limits, dividend policy). There have been seismic changes in monetary policy to curb inflation. Understanding the impacts of current decisions in the context of a dynamic inflationary environment is both complex and multi-dimensional. It is time for financial modelling to endeavour to best understand cause and effect. Let's not forget Milton Friedman, the good effects come first, the bad effects only come later....

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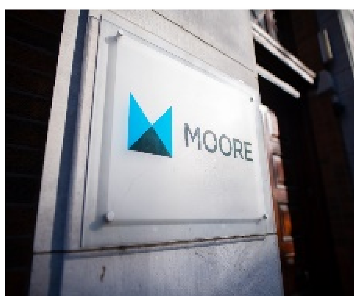

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