

# Inflation's Effect on the Banking Sector's Performance

Mohd. Saleem, Assistant Professor,

College of Computing Sciences and Information Technology, Teerthanker Mahaveer University, Moradabad,  
Uttar Pradesh, India

Email Id- saleem0642@gmail.com

**ABSTRACT:** *Even foreseeable rises in the rate of inflation interfere with the financial sector's capacity to allocate resources electively, according to a growing theoretical literature. These predictions are tested experimentally in this article. According to the data, there is a substantial and economically significant negative connection between inflation and the growth of the banking sector and stock market activity. The connection is also nonlinear. The marginal effect of inflation on bank lending activity and stock market growth decreases quickly as inflation increases. We also have evidence of thresholds. There is a noticeable decrease in financial sector performance in countries with inflation rates over 15%. Finally, although statistics show that higher inflation is not matched by higher nominal equity returns in low-inflation nations, nominal stock returns in high-inflation economies move almost one-for-one with marginal rises in inflation.*

**KEYWORDS:** *Banks; Financial, Inflation, Markets.*

## 1. INTRODUCTION

There is currently a significant body of research suggesting that persistent and, therefore, likely predicted high rates of inflation may harm an economy's long-run rate of real growth or level of real activity. This discovery begs the obvious question. Even foreseeable rises in the rate of inflation interfere with the financial sector's capacity to allocate resources electively, according to a growing theoretical literature[1]. More specifically, recent theories emphasize the importance of informational asymmetries in credit markets and show how increases in the rate of inflation negatively affect credit market frictions, resulting in negative consequences for financial sector (both banks and equity market) performance and, as a result, long-run real activity.

The fact that there is endogenous informational friction is a common characteristic of these theories. Because of this characteristic, a rise in the rate of inflation lowers the actual rate of return on all assets, not just money. Credit market frictions are exacerbated by the anticipated decrease in actual yields. Credit rationing gets more severe when inflation increases because these market frictions lead to credit restriction. As a consequence, the banking sector provides fewer loans, resource allocation is less efficient, and intermediary activity declines, reducing capital investment opportunities[2]. Reduced capital creation has a detrimental impact on both long-term economic growth and stock market activity, which trades claims to capital ownership. Existing models also highlight that informational frictions only play a significant impact when inflation surpasses certain key rates [3], [4].

When inflation is low, for example, credit market frictions may be nonbinding, preventing inflation from distorting information flow or interfering with resource allocation and growth. When the rate of inflation reaches a certain threshold, credit market frictions become binding, and financial sector performance suffers a discontinuous decrease as credit rationing intensifies. These models also anticipate the presence of a second inflation rate barrier. When inflation rises beyond this level, perfect foresight dynamics are linked with endogenous

oscillation in all variables, resulting in inflation being strongly connected with inflation variability and asset return volatility.

In addition, similar models indicate that there is a third inflation threshold. Perfect foresight dynamics may not enable an economy to converge to a stable state showing either an active financial system or a high level of real activity if the rate of inflation reaches this crucial threshold in certain circumstances. Further rises in inflation have no further negative impact on the financial system when this happens. As a result, these models suggest that once the rate of inflation exceeds a particular critical level, all of the financial system's harm has already occurred. Inflationary rises will have no further impact on financial sector performance or economic development[5].

As a result, the theoretical literature on credit market frictions, finance, and growth provides experimentally tested implications for the effects of greater long-run or permanent inflation rates:

- Higher inflation rates are linked to higher inflation and stock return volatility.
- Inflationary pressures mean less long-term financial activity. Intermediaries will lend less and distribute money more selectively in high-inflation countries, and stock markets will be smaller and less liquid.
- The connection between inflation and financial sector circumstances may be described by a number of inflation thresholds. Most notably, once inflation reaches a critical level, further rises in the (long-run) rate of inflation may have little effect on financial sector activity.
- Higher long-run inflation means lower long-run real activity levels and/or slower long-term growth rates.

This study assesses these theoretical assumptions about the financial system's effect of foreseeable inflation. Because a vast and increasing literature already demonstrates that the financial system affects long term rates of economic development, we focus on the connections between persistent inflation and financial sector performance[6]. As a result, we use data from up to 100 nations throughout the period on inflation, banking sector activity, equities market size, equity market liquidity, and stock return rates.

We mainly utilize data averaged across the whole time, such that we have one observation per nation, since the major theoretical predictions we examine involve the implications of various long-run rates of inflation. The cross-sectional connection between inflation and banking sector conditions is next examined. We may concentrate on the long-run instead of the cyclical connection between inflation and financial sector activity by aggregating the data. However, as explained below, we additionally use a panel estimator to take advantage of the data's time-series dimension and account for potential endogeneity and omitted variable bias that the pure cross-sectional estimator introduces.

We also look for possible nonlinearities in the data and explore alternate hypotheses about the connection between inflation and financial sector performance from a methodological standpoint. A fiscal narrative is an alternate hypothesis in which governments combine high inflation with different banking sector limitations to assist finance spending. As a consequence, their financial systems are underdeveloped, and inflation is rampant. A second narrative is simply passive: greater growth (from sources other than the economy) means lower inflation,

ceteris paribus. Higher real activity means that quickly expanding countries have more rapidly developing financial systems than slowly growing economies if financial services are considered a typical good. As a result, when looking over extended periods of time, one source alone may reveal a negative connection between inflation and financial progress[7].

As a result, we use a conditioning information set to account for alternative theories of the finance-inflation connection and regress each of our financial sector conditions on inflation. We include a measure of fiscal circumstances as well as a collection of variables to account for economic growth and other factors that influence banking sector development. Furthermore, we account for nonlinearities in the connection between financial sector performance and inflation in certain econometric assumptions. In one specification, we look at threshold connections by allowing:

- the inflation relationship's intercept to move after inflation reaches a certain threshold rate,
- the inflation relationship's slope to change as well.

We modify the data in a second specification to account for nonlinearities that aren't defined by discrete thresholds. The following are the outcomes we obtain:

- There is a significant negative relationship between inflation lending by the financial sector to the private sector, the quantity of bank assets, and the volume of bank liabilities issued at low-to-moderate inflation rates.
- Inflation and indicators of stock market liquidity and riding volume have a strong negative connection for low-to-moderate rates of inflation. Inflation and stock return volatility have a strong positive connection.
- The evidence strongly suggests that there is a nonlinear connection between inflation and financial sector performance, perhaps driven by inflation threshold rates. Financial sector performance declines when inflation increases, although the marginal effect of further inflation on the financial industry decreases quickly. Thus, as the average annual rate of inflation reaches 15%, financial sector performance plummets, while the partial connection between inflation and measures of intermediary or stock market activity completely vanishes.
- The evidence suggests that inflation and nominal stock returns have a nonlinear connection. Again, inflation threshold rates may be to blame for this nonlinearity. For example, we found that nominal stock returns are roughly uncorrelated with inflation in countries with average annual inflation rates below 15%. However, for countries with inflation rates over this level, inflation and nominal equity returns are almost identical.

The results of this study, which are based on pure cross-sectional regressions, are consistent with models that stress that foreseeable inflation may increase informational frictions and hinder financial sector performance, resulting in negative economic activity. Because previous research has shown that the operation of banks and stock markets may have a significant impact on long-run economic development, this study focuses only on the connection between persistent inflation and bank and equity market functioning. As a result, its primary contribution is to provide light on the effect of low inflation on financial sector performance. We supplement our cross-sectional study with an alternate estimate method to evaluate the confidence with which we may make this causal assertion [8].

Our results are unaffected by using the panel-GMM estimator. There is a significant negative relationship between inflation and financial intermediary development in nations with low-to-moderate inflation rates. Furthermore, the partial connection between inflation and intermediate activity decreases as inflation rates increase. These findings confirm the above-mentioned theoretical expectations, illuminating one mechanism via which predicted rises in the inflation rate interfere with resource allocation and economic development. To account for possible biases caused by country-specific effects and endogeneity, we utilize the system, dynamic-panel GMM estimator.

Other sensitivity analyses, such as panel estimation We look at the sensitivity of the findings to modifications in the sample period, nation sample, conditioning information set, financial sector development indicators, and econometric method in this section.

### *Analyses of sensitivity*

We looked for outliers in two methods to see whether they had an impact on our findings. First, we eliminated countries with very high inflation from the sample and re-estimated all of the regressions[9]. Argentina, Brazil, Bolivia, and Peru were included in the banking development data set, whereas Argentina, Brazil, and Sri Lanka were included in the stock market data set. The absence of these nations had no significant impact on our results. Second, we used the method outlined in Greene to test for the influence of important data points, with a critical value of 2.5. The removal of country data that have a significant impact on the residuals of each equation has no effect on our findings. estimate by a panel The findings of a panel estimator are presented in this section.

The panel estimation:

- Takes use of our data set's time-series dimension
- Accounts for the potential that an essential country-specific variable is causing omitted variable bias.
- Takes into consideration the likelihood that financial market performance and inflation are both determined factors at the same time.

For the banking performance metrics, we do the analysis. We can't use panel estimate using stock market data since there aren't enough observations from enough nations. A total of 64 nations are shown in the panel, which spans the years 1960 to 1995. We average data across 5 year non-overlapping periods, resulting in seven observations per nation and a sample size of 448. As a result, the subscript  $t$  in the following refers to one of these five-year intervals[10].

## 2. DISCUSSION

The data suggests that inflation and financial development have a substantial, and economically significant, negative connection. This relationship appears basically regardless of the time period studied, the empirical method used, or the collection of variables included in the conditioning data set. It is also unaffected by whether or not nations with very high inflation rates are included or excluded. Finally, even after adjusting for simultaneity and omitted variable biases, the negative connection between inflation and financial sector performance reappears. As a result, the overwhelming evidence suggests that prolonged inflation and financial sector performance have a significant negative relationship. Furthermore, the actual connection between inflation and financial sector activity is extremely nonlinear, as we

discovered. In low-inflation nations, for example, the statistics show that higher inflation is not matched by higher nominal stock returns. We also discover evidence of thresholds. According to the statistics, there is a significant distinct decrease in financial sector growth for nations with annual inflation rates over approximately 15% compared to those with inflation rates below this threshold. This result is in accordance with the hypotheses presented in the introduction.

### 3. CONCLUSIONS

Predictable rises in inflation, according to recent theoretical work, may exacerbate informational asymmetries, resulting in less intermediary or stock market activity. Recent research indicates that a decline in financial sector performance has significant negative consequences for economic development. According to theory, the inflation-finance connection may have significant nonlinearities. Informational frictions, for example, may only become binding when inflation reaches specific levels. When inflation reaches these levels, some models predict a breakdown in financial system functioning, with negative consequences for resource allocation and economic activity.

Because prior empirical work has focused on the effect of financial sector development on economic growth, this article focuses on testing these theoretical predictions about the impact of persistent inflation rates on financial sector performance experimentally. Nominal stock returns in high-inflation countries, on the other hand, rise in lockstep with marginal increases in inflation rates. The statistics also show nonlinearities in terms of banking and stock market development. Bank lending activity, bank liability problems, stock market size, and liquidity all have significant negative relationships with inflation, but only in nations where inflation is low to moderate. The marginal effect of extra inflation on banking and stock market growth decreases quickly as inflation increases. Because financial sector growth is so closely connected to long-run economic performance, our results support the theory that when inflation, even predictable inflation, approaches certain key levels, it will have negative consequences for long-term economic performance.

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