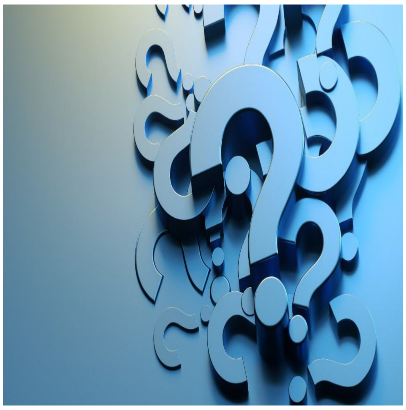

Who Benefits Most From a 30-Year Historic Inflation: Lenders or Borrowers?

Description

With inflation at a 30-year high, inflation phobia is spreading almost as quickly as the virus that produced it. The laundry list of items that are now more expensive grows longer by the day. And, unless the Bank of Canada can curb high inflation with rate hikes, that list might very well continue to grow late into the year.

High inflation makes the Canadian dollar worth less today than it was worth last year. That begs the question: who benefits most from high inflation, the lender or the borrower?

How inflation helps borrowers

In general, borrowers benefit from high inflationary periods when they took on fixed-rate debts *before* high inflation kicked in.

It's simple to understand why. When a borrower takes out a $20,000 loan to buy a car, she's obligated to repay the full $20,000 (plus interest). If the same car is worth $22,000 the next year (due to inflation), that doesn't change the amount on the loan. A $20,000 loan is still a $20,000 loan, even if $20,000 in today year's dollars holds less value than last year's.

This devaluation of dollars could hurt the lender. They'll still get their $20,000, true. But that sum now has less purchasing power. Of course, there's APR, initiation fees, and other expenses that ensure the lender doesn't lose money. But high inflation could mean a cut in profits, especially if the borrower pays the loan back in a shorter amount of time than expected.

Aside from money losing its value, high inflation might profit borrowers in another way: higher wages. Often, when inflation is high, employers will raise wages (whether voluntarily or compulsory). The increase in wages matches the higher inflation rates, which, in an ideal world, balance each other out. But, with fixed-rate debt, higher wages mean borrowers have the opportunity to pay back more of their loans. In theory, borrowers could pay their loans faster, which means they can spend less on interest, saving them money.

How inflation helps lenders

In general, lenders benefit from inflation when consumers borrow money during high inflationary periods.

Again, this isn't complicated to understand. If a car costs $22,000 this year versus $20,000 last year, the lender will make more money off the $22,000 loan than the $20,000 one. Consider a loan that has a 10% APR. At 10%, the lender will make $2,200 per year on the $22,000 loan versus $2,000 on the $20,000 loan.

High inflation can also help lenders if consumers who don't normally borrow are forced to take out loans. In this way, high inflation can bring in more clients, as consumers need help buying items they can no longer afford on their own.

How high inflation can hurt both lenders and borrowers

There is one scenario in which inflation can hurt lenders and borrowers: defaults.

High inflation increases the cost of living. Unless a household's income increases with inflation—that is, unless they get a wage hike that matches inflation—they might find themselves with less purchasing power. That could result in a household putting less toward debts and more toward essential purchases. The longer they postpone paying off their debts, the more interest they incur, and the higher the likelihood of defaulting.

Defaulting doesn't benefit anyone, neither the borrower, nor the lender. For one, the lender might have to agree on a debt settlement or pay legal fees to get their money back from the borrower. The borrower, for their part, will see a massive drop in their credit score, one that will take years to fix.

There might be a solution for Canadians facing default: a balance transfer credit card with a low introductory APR. If you can transfer your debts to a credit card with a low APR, you'll pay less in interest. Of course, the introductory APR is a promotion: it will become a normal high APR at some point. That said, the low APR will ensure you don't wrack up more debt, especially if you're struggling to pay your debts at this time.

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