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Inflation and Bank Profits: Monetary Policy Trade-offs

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STAFF DISCUSSION NOTE

Executive Summary

Given the recent generational surge in inflation, this Staff Discussion Note examines how inflation affects bank profitability. Bankers—and the media—often suggest that bank profits vary significantly with inflation and interest rates. From a policy standpoint, if sharp monetary tightening in response to high inflation hampers bank profitability beyond any effects of inflation itself, central banks would be constrained in their ability to restrain inflation due to concerns about financial instability. Despite its importance, evidence on this question is scant. This note attempts to fill this gap.

Banks' income and expense tend to rise with inflation. Inflation shapes the operating environment for banks both directly and through its impact on policy rates. Unexpected inflation directly increases non-interest incomes and expenses, such as income from non-traditional banking services and operating costs, independently of the macroeconomic environment and whether central banks raise policy rates. And to the extent that higher inflation prompts central banks to raise policy rates, it increases interest income and expense derived from borrowing and lending. Exposures vary significantly across countries due to differing contracting conventions, regulatory frameworks, business models, and competitive pressures, but are typically larger in the interest-rate business.

While these large "gross" exposures create room for vulnerability, most banks tend to match income and expense exposures and see little change in profitability as inflation shifts. Most banks appear to be operationally hedged to inflation. Indeed, bank profitability shows little exposure to inflation across a wide range of banks and countries over the past three decades.

However, some banks are vulnerable to rising inflation and interest rates because of different risk management practices and business structures. Estimated bank-level exposures to simultaneous increases in inflation and policy rates seen in 2021–23 are large in both directions for some banks. Advanced economy banks appear more likely to benefit from the environment, whereas outliers among emerging market and developing economy banks are more evenly distributed. Some 3 percent of advanced economy and 6 percent of emerging market and developing economy banks, comprising 8 percent of assets in the average country, have interest-rate exposures at least as large as Silicon Valley Bank's at the onset of its failure. Accounting for non-interest exposures as well, 5 percent of advanced economy and 8 percent of emerging market and developing economy banks—comprising 9 percent of assets in the average country—could experience losses greater than 2 percent of assets. Data up to 2022 confirm this predicted dispersion in performance and suggest that some banks have already seen hits to profitability.

If losses at individual banks leave room for wider contagion—despite strengthened regulation and supervision and other ex-ante measures—central banks could face material price–financial stability trade-offs. On one hand, this note offers good news: Across a wide range of countries, there is little evidence that banks are meaningfully exposed to monetary policy tightening to tackle spikes in inflation. On the other hand, such tightening might generate large losses for outlier banks, further exacerbated by supply-driven inflation surprises that may precede tighter monetary policy, as was the case in 2022. Strengthened prudential regulation and supervision, heightened requirements for risk management governance, improved transparency, and using granular risk assessments to calibrate micro- and macroprudential capital requirements along the key dimensions highlighted in this note are important to limit the risk of such exposures. If losses do emerge—even if limited to outlier banks—concerns about individual banks could trigger a reassessment of the entire sector and lead to panic-fueled contagion with systemic consequences, within and across borders.

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