IMPACT OF AFTER COVID INFLATION ON INVESTOR PROTECTION

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Abstract: The after COVID inflation that started in the late 2021 seriously affected all EU economies. This paper aims at investigating how inflation impact the value of client assets invested on the capital market. It also concerns the issues of investor protection of such assets. Inflationary periods are stressful for the whole economy and especially for consumers. The longer inflation lasts the more significant impact it may have on investor behavior. In this paper it is argued that on a short term basis inflation could not be compensated at stock market prices but on a long term the capital market stock market returns overwhelms inflation. Investor protection regards the financial safety net which includes deposit guarantee and investor compensation schemes, which provide protection to investors at European level. Investor compensation schemes have not increased the level of protection for decades which due to the higher inflation rate causes a decreasing real protection. Deposit guarantee schemes on the contrary have imposed very high limit of protection in 2009 and 2010 which is 5 times higher than the minimum required limit on the EU level.

Keywords*: capital market, inflation, return, investor protection.*
JEL codes*: G01, E66, E43, E63.*

Introduction – Review of inflation and stock market

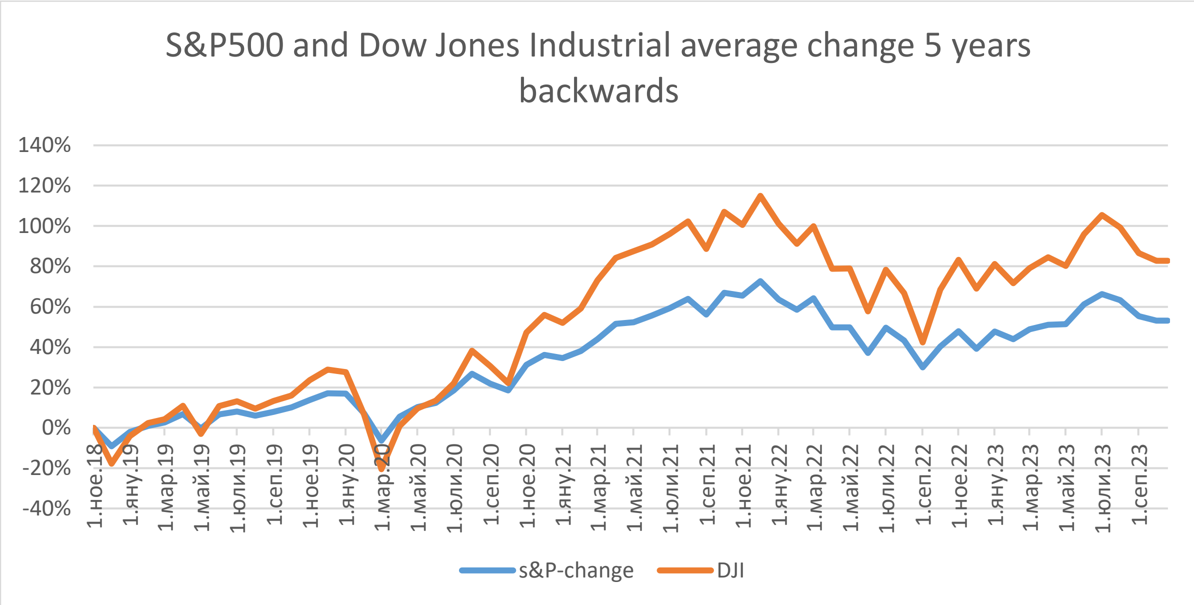
Inflation always triggers the discussion on the type of investment that can protect savings against it. Weather deposit, property or investment on financial markets – investors look for an appropriate decision when choosing how to save the value of their earnings. In almost a decade of negative or zero interest rates deposits were rather a non option but however in most of that time inflation was also very low, which finally kept deposits with banks. Since the end of 2021 on the other hand and the rise of inflation investors became more inpatient.

While it is easy to observe the impact of inflation on goods and services it is not the same direct connection with the inflation impact on investment instruments like stocks. Capital market does not sell goods and services and therefor prices are not so directly affected by inflation measured by the CPI.

Revenda and Arltova (2022) show that there is strong impact of inflation on both the stock index and gold where the market price of gold was partly influenced by the development of market stock prices.

Lets overview the main indexes of stock markets at the next figure - information about the changes of S&P500 and DJI indexes is shown for a 5 years time frame period.

Fig. 1



Source: *yahoo finance.*

The S&P500 index shows increase over the years by 35-65%, while DJI shows higher increase, while the curves tend to move together. At the end of the period tDJI is more than 80% higher while S&P is approx. 48% higher.

In the same time inflation for USA for a 5 years time frame is 16,7% (cumulatively).

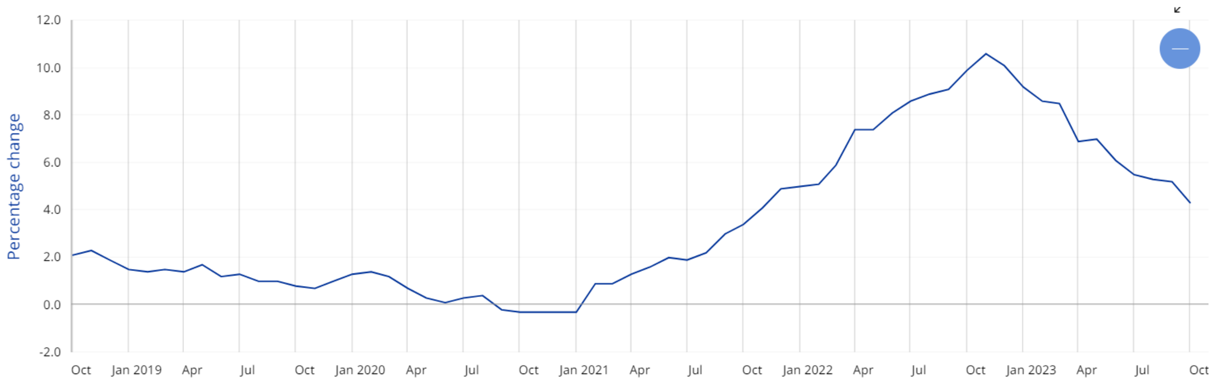
Fig. 2

United States Inflation Rate

In contrast, inflation (HIPC) in Euro area for the same period tend to be higher– where the cumulative value is approx. 23%.

Fig. 3

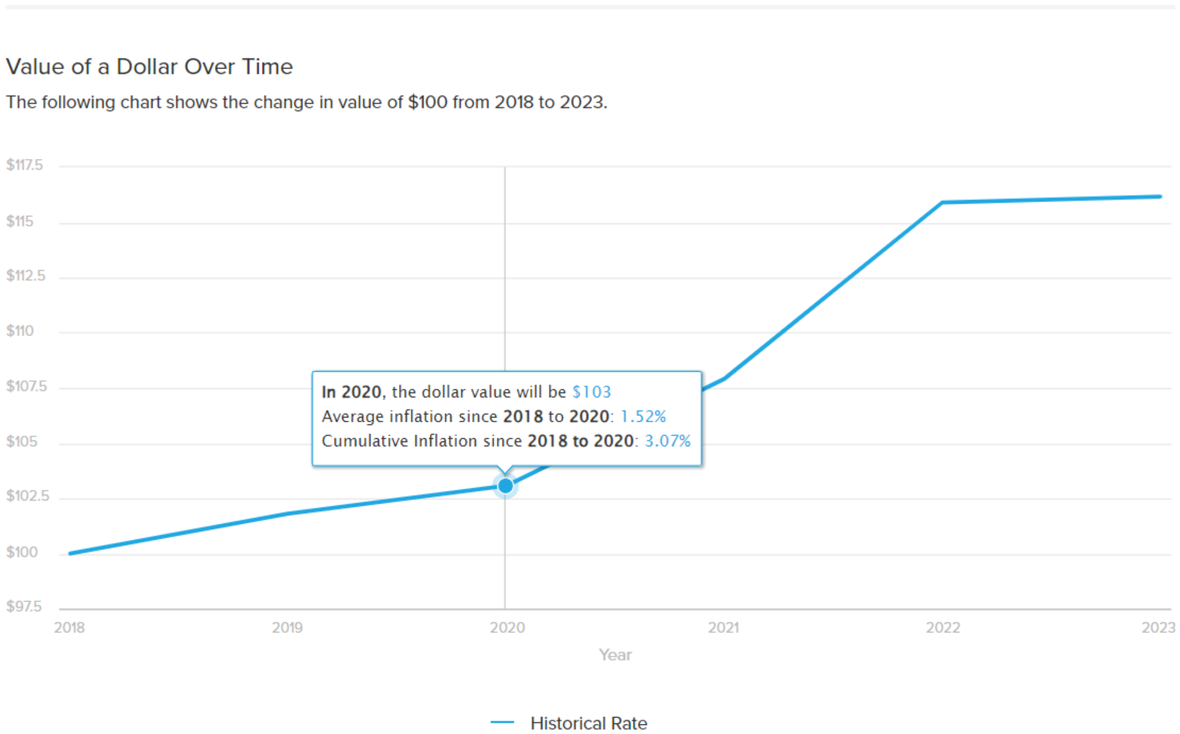
EU inflation for a 5 years time frame



Source: *ECB statistics.*

Fig. 4

Cumulative inflation in USA



Source: https://smartasset.com/investing/inflation-calculator

At first sight it is clear that the cumulative inflation is far lower than the increase of capital market price indexes. In long term the return on the capital market is much higher than the cumulative inflation, still in some periods, for a short-term, when there is a boost of inflation the stock market prices might need some time to react and therefor could score lower short term return. Capital market is attractive for short term investors looking to scalp the market and win from higher volatility but also there are long term investors who keep their investments even during hard inflationary times.

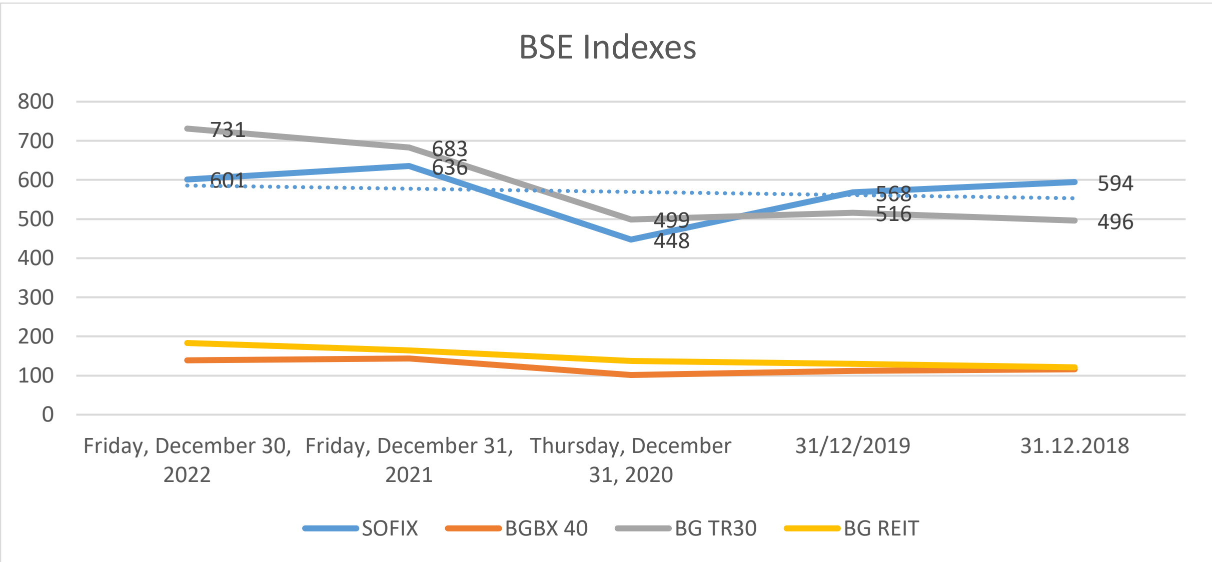
There could be some reasons for investors to withdraw from the market in a high inflation times. First of all, one reason is a necessity for liquidity which may forse investors sell their assets. Second, it could be interest of a higher return opportunities, still it is important to observe if such opportunities truly exist. The third option is the fear of lost of value of savings, as in times of high inflation companies become more vulnerable and riskier, some business might get hurt and thus investors may look for different investment opportunities.

Capital market assets

Not only return on the capital market is important, but also the amount invested. As of the end of 2022 the investors client assets kept and managed by Bulgarian investment companies is approx. 25 bill. euro, scoring increase of 3.5 bill. euro compared to 2021. End of 2021 was negative in this perspective as the client assets decreased by 4 bill. euro in comparison to 2020 and 2019 (ICF, 2021,p.14) , (ICF,2020, p. 15).In comparison, in 2018 that value was 21 bill. euro. In a time of inflation there was a decrease of client assets value, but the recovery was rather quick. This decrease could be either due to a clash of prices or to a withdraw of investors.

In the same time Bulgarian stock exchange indexes show that there is an increase in 2022 compared to 2018 (Fig. 5).

Fig. 5



Source: *Bulgarian Stock Exchange*

Key problem in 2022 is the increase of not only inflation but also major interest rates. The European central bank started tightening its monetary policy by raising the main interest rates in the second half of 2022 which continued in 2023 too. Those measures aim at getting inflation under control, which on the other hand will be at the price of slowing down economy growth. The energy crises could also challenge the sustainable goals of the European program.

The fact that the amount of clients assets on capital market and capital market indexes increase over the time shows that rather investors tend to trust and look for investment opportunities on the capital market, being not afraid of inflation. Another way saying, inflation is compensated by capital market performance.

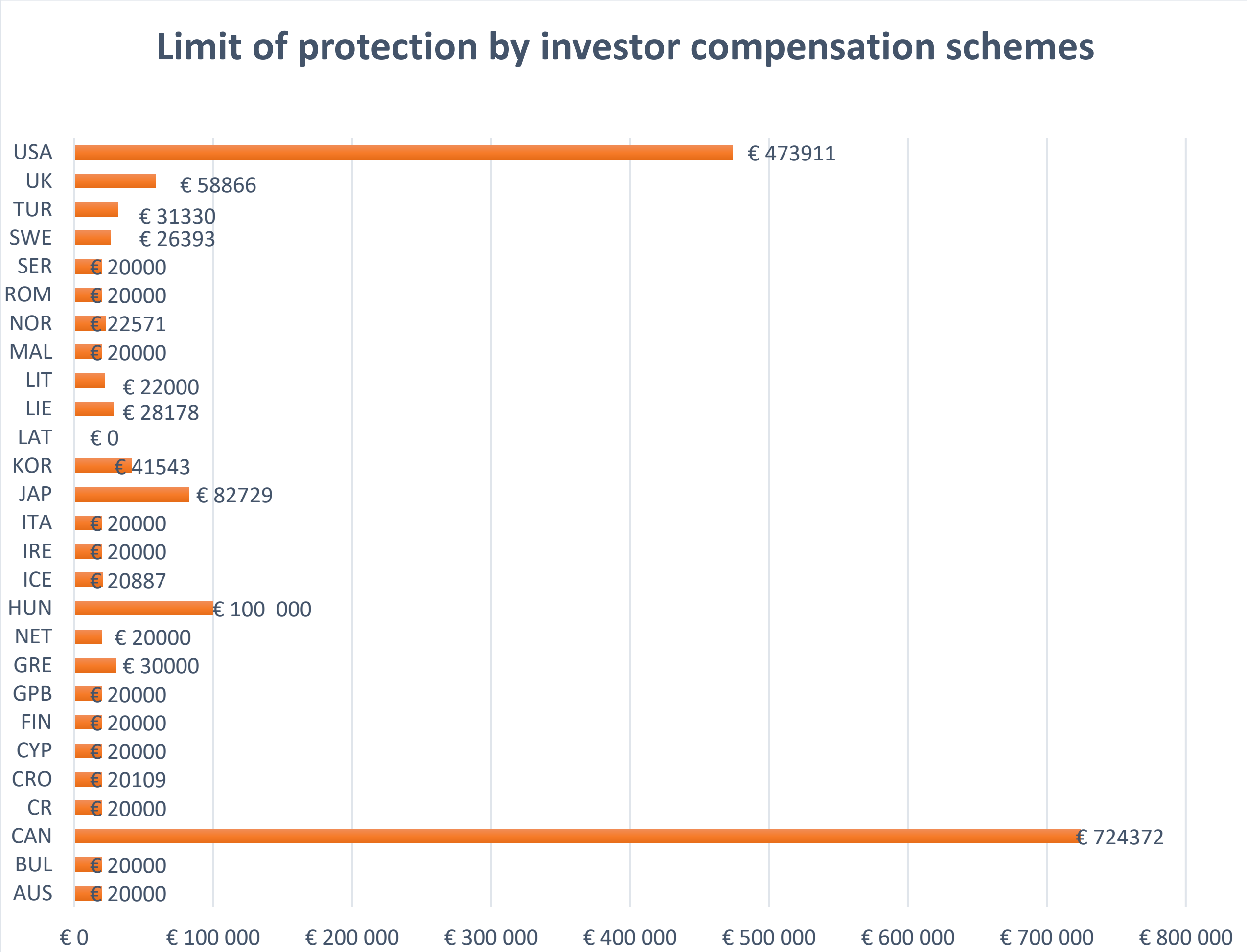
What is happening with investor protection on the other hand. Definition of investor protection could include different perspectives of understandings. All legal financial framework aims to build markets where investors feel confident and protected from losses which are not connected with their investments, which means that are not part of market risk. How actually inflation impacts this protection? Among all types of protection a direct connection can be found with the protection of deposit guarantee schemes and investor compensation schemes. The last two type of institutions aims to prevent a certain amount of investors funds, to be compensated in a case the broker (bank, investment firm etc.) is not able to return it. That certain amount is called protection or compensation limit.

In Europe the deposit insurance protection limit since 2010 has been increased to 100 000 euro according to par. (21) and art. 6 p.1 of the Directive 2014/49/EU for deposit insurance schemes. Prior to 2010, there was a requirement for at least 20 000 euro protection limit, which was in place for the majority of European countries.

Hence, in terms of investor compensation schemes, which protect investors in financial instruments, the minimum limit of protection set by the EU Directive is still 20 000 euro which is provided by the majority of EU schemes.

On the next figure the compensation limit around the world is given. The importance here is that the limits in the EU countries have almost not changed for the last 25 years, with small exclusion.

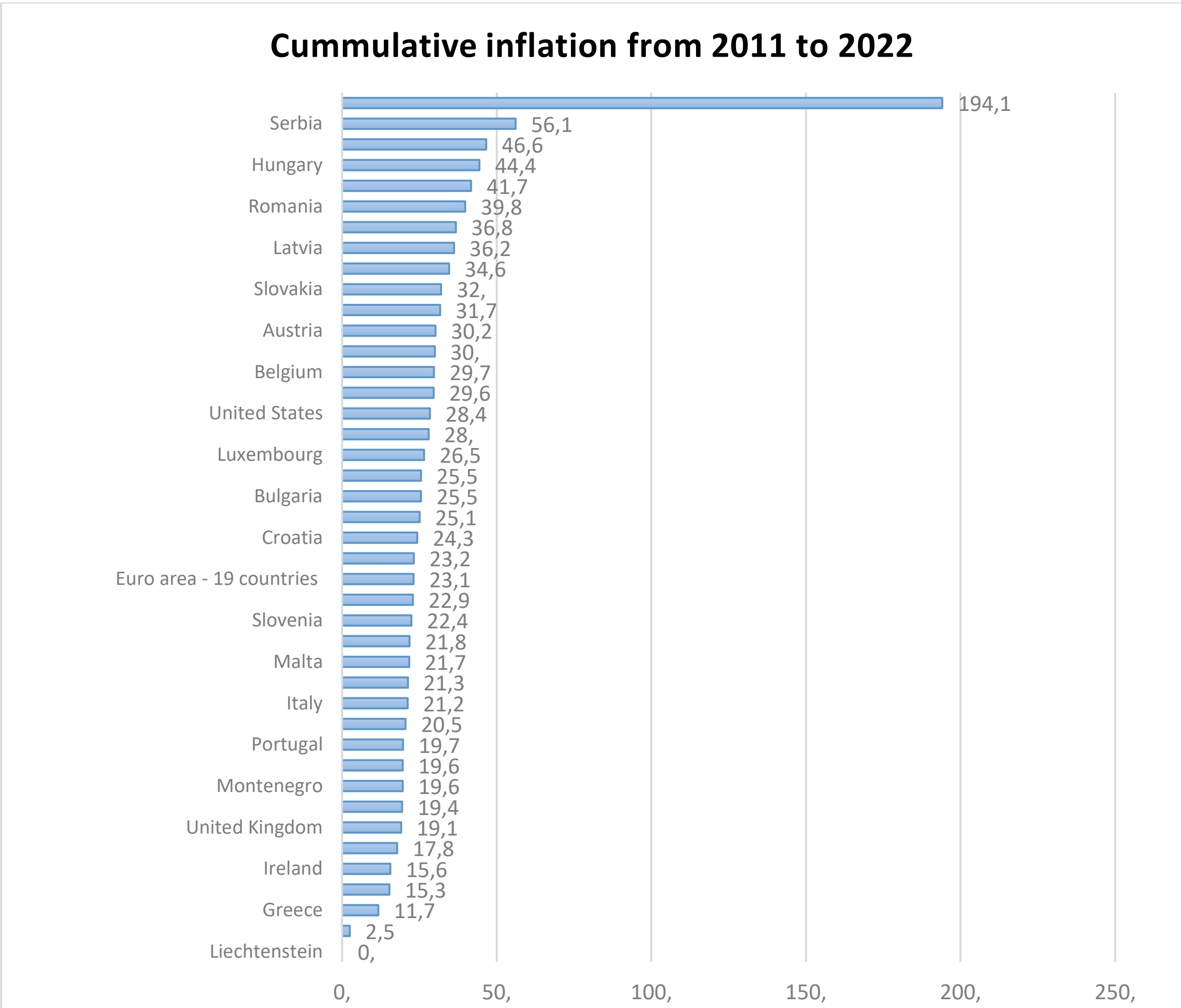
Fig. 6



Half of the schemes have a protection limit of EUR 20 000 or just over this amount, the reason for this has been the Directive which regulates the establishment and operation of these institutions, where a minimum level of protection of EUR 20 000 is set. This is considered to be an appropriate level in 1997 when the Directive was approved. In Bulgaria, for example, over 95% of investors in financial instruments are fully protected up to this level, and this is the situation in most European countries. On the other hand, this minimum level has not been changed since the Directive was introduced in 1997 (now 20 years). Here we come to one of the controversial points and questions about whether the level should be raised and to what amount would be appropriate. The cumulative inflation in Bulgaria for the period 1999-2023 is 189%, according the statistics of the NSI.

However, if we observe inflation in Europe for the period 2011-2022 on Fig. 6, it varies between 11 and 56%.

Fig. 7



If the accumulated inflation for the period 1997-2022 is considered the level should be increased at least by 30-40% or reach approx. 30 000 euro.

The other issue is whether the level should be brought in line with that for deposit protection, which could be challenged as being too high and undermining the financial sustainability of the schemes. On the other hand some countries show interest of equaling the levels of protection for deposits and financial instrument in order to give equal protection for investors. The European countries which provide higher limit are Hungary, Spain, France, Greece, Lithuania, Sweden and Turkey.

In the US, the protection limit is USD 500,000 with an additional USD 250,000 cash limit, indexed to inflation, subject to discussion every 5 years. The limit in England is £50,000, which is significantly higher than the Directive. However, the English scheme has vast experience in paying compensation and regularly changes the limit if there are prerequisites to do so. Also, the English capital market is significantly more developed than other European markets, which also argues for the higher protection. Although Latvia is indicated in the figure with a zero limit, it provides compensation for 90% of the value of irrecoverable or lost financial instruments or damages arising from non-performed investment services , but not more than the equivalent of EUR 20 000. The highest protection is provided by the Canadian scheme - EUR 724 thousand.

Conclusion

This paper aimed at overlooking the inflation and capital market assets and their protection provided by investor compensation schemes. The analysis showed that cumulative inflation is less than the increase of the capital market prices which confirms the statement that in a long turn investments on capital market outline inflation. On the one hand there is significant inflation, but on the other there is a significant rise of client's assets prices. Those are two effects that makes it necessary the limit of compensation to be risen, as the real protection of investors in financial instruments is going down in terms of rising inflation. This events also may make one investors to shift its assets to another provider offering higher return. The after crisis regulation was aimed at rising investors protections in all kind of legal requirements and administrative measures, but the real money protection was forgotten to be adapted at a reasonable level along the time.

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