



WHY ARE INTEREST AND INFLATION IMPORTANT?



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Interest earnings bring income to the association that inflation takes away. But do they offset each other? Well first, it helps to understand the difference between the two. Interest earnings are income the bank shares with you from profits they have made with the money you deposited in their institution. More interest earnings are good, as they mean fewer owner contributions are needed to pay bills. Inflation, however, is far more significant to an association than interest, because inflation works its effect on the *entire value* of all your Reserve components. Interest is only earned on the much smaller amount of Reserve cash actually on deposit in the bank.

When it comes to interest and inflation, it's important to avoid these two common mistakes:

- 1. Ignoring them both.** In this case, you are effectively assuming interest and inflation are both zero. Even a bad guess for interest and inflation values will likely be closer to reality than guessing they both will be zero. Presuming they both will be zero, even if you update your Reserve Study each year, will lead to continually being underfunded. The result will be chasing after higher and higher expenses, as your costs increase each year and your income needs to be raised in an attempt to regain lost ground.
- 2. Counting on interest to offset inflation.** Because inflation works on the entire "value" of your Reserve expenses, inflation has its full effect every year. Interest is only earned on the fractional amount of Reserve expense cash that you actually have set aside in the bank. For example, while an association is gradually building funds in anticipation of a \$10,000 expenditure, in all those years the cash balance is less than the replacement value. Every year, interest is only earned on the cash balance (\$2,000 one year, \$5,000 another year, \$8,000 another year, etc.) while every year inflation has its compounding effect on the entire \$10,000. Expecting interest to offset inflation will always be a losing game of catch-up.