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Effects of prolonged increase in interest rates on consumers and businesses

Summary:

The South African Reserve Bank (SARB) has raised the repurchase rate (repo rate) by ***about 4.75%, from 3.5% in October 2021 to 8.25% in May 2023.*** Similarly, the prime lending rate increased from ***7% to 11.75%*** during the same period. The current increase in interest rate is attributable to factors such as ***persistent inflation rate, which picked at currency volatility (exchange rate), and extensive electricity load-shedding. For example:***

- ***Inflation increased from 2.1% in May 2020 to 6.5% in May 2022***, breaching the upper band of the ***targeted range (3% to 6%).*** It remained elevated above this range***, peaking at 7.8% in July 2022 before slowing to 6.3% in 2023.***
- The South African rand depreciated by more ***than 26% against the United States of America (US) dollar, from R15.62 in May 2022 to R19.72 in May 2023***. It, however, recovered some of its losses and traded at an average ***of R18.82 in June 2023.***

The repo rate hikes imply high borrowing costs and debt service costs which could ultimately result in financial distress, especially for consumers who financed their assets with a *linked-interest rate* as their monthly payments change with the prime lending rate. ***For example:***

- ***A typical car owner with a vehicle loan of R280 000 on a 72-month payment plan, at the current prime rate of 11.25%, will likely pay about R847 higher on their monthly instalments.***
- ***At the current prime rate, a homeowner with a bond of R1 million over a 20-year repayment term will likely pay about R2 933 higher on their monthly instalments.***

From a business perspective, the higher borrowing costs affect cash flow and limit their expansion initiatives.

1. Introduction

The Coronavirus (Covid-19) pandemic resulted in a reduction in economic activity more severe than any other short-term fluctuation or crisis ever experienced since the Great Depression[1]. This disruption to the economy warranted strategic monetary and fiscal policy responses. These monetary policy responses, in both advanced and emerging market economies, involved the application of various tools to cushion the impact of the pandemic on economic activity and the financial sector. In the South African context, the South African Reserve Bank (SARB) applied multiple tools, including a significant reduction of the repurchase rate (repo rate)[2], thanks to a flexible exchange rate, credible monetary policy regime, and low inflation. The repo rate dropped to a historic low of ***3.5% in July 2020***, taking the prime lending rate to ***7%***.

As an open emerging economy market with strong ties to international markets, South Africa's (SA) economy is vulnerable to external shocks[3] and changes in global trade patterns. As the world economy was still recovering from a downturn resulting from the global pandemic, it was hit by another significant shock when Russia invaded Ukraine early in 2022. The highly volatile commodity, energy and financial markets directly affected the local economy. Resultantly, headline inflation began to accelerate persistently amid higher food and transport prices. Transport prices were influenced largely by higher fuel costs owing to soaring international crude oil prices and a weaker rand/dollar exchange rate.

The unfavourable international economic conditions coincided with numerous local structural constraints as the energy crisis intensified. In response to these developments, the SARB implemented a tighter monetary policy (increasing interest rates) stance in an attempt to contain inflation. The SARB has raised the repo rate by an accumulative ***475 basis points or 4.75%,*** leading to the prime lending rate increasing from ***7% in October 2021 to 11.75% in May 2023.***

Against this background, this article briefly discusses the context within which the current monetary policy response is being implemented and possible implications for consumers and firms. The article begins with an overview of major factors that necessitated a hiking cycle. This is followed by a repo-rate trend analysis covering the period before the Covid-19 pandemic and the post-pandemic era. The possible implications for consumers and firms are discussed before concluding remarks.

[1] The Great Depression (1920s to 1939) was the worst and most prolonged economic recession in modern history. It was partly caused by the 1929 stock market crash, the collapse of international trade, and bank failures and panic.

[2] The repo rate is the rate at which the central bank of a country (SARB) lends money to commercial banks. The repo rate is used by the SARB as an instrument to effect monetary policy adjustments to influence output and price levels.

[3] External shocks are unexpected events that come from outside a domestic economic system which may have a good or bad impact on the domestic economy's performance.

2. Factors influencing repo-rate adjustments

Central banks implemented monetary policy tightening in many countries worldwide, South Africa included, due to persistently high inflation rates in 2022. However, most central banks, particularly in Europe and the United States of America (USA), began to ease their hiking cycle as the inflation rate peaked towards the end of the year. The SARB has continued with aggressive repo rate increases into 2023. According to the SARB, the current implementation of a tighter policy stance is partly due to the persistent ***inflation rate, currency volatility as well as extensive electricity load-shedding.*** The electricity load-shedding has increased the risk of an economic contraction and raises the cost of doing business as well as the cost of living.

Inflation rate

As highlighted in the preceding sections above, the rising headline inflation rate has been a primary concern for central banks worldwide. According to the International Monetary Fund (IMF)[4], the soaring inflation rates worldwide were caused by numerous demand and supply factors. The demand side factors include the acceleration of growth during the initial rebound from the 2020 global recession, as well as the lagged effects[5] of earlier macroeconomic support. On the other hand, the supply-side factors include higher energy and food prices due to shortages of key commodities caused by the Russia-Ukraine war. However, inflation in many countries peaked towards the end of 2022, leading to the easing of these countries' monetary policy tightening cycle.

In SA, however, the annual consumer price inflation moved from a low rate ***of 2.1% in May 2020 to 6.5% in May 2022***, breaching the upper band of the ***targeted range (3% to 6%).*** The inflation rate remained elevated above this range***, peaking at 7.8% in July 2022 before slowing to 6.3% in May 2023.*** The persistent inflationary pressure is driven mainly ***by food (11.8%),*** transport ***(7%)*** and other costs. Electricity load-shedding also contributes to inflationary pressures by elevating the costs of doing business, which is ultimately transferred to consumers.

Exchange rate

Monetary policy tightening, especially across advanced economies, greatly affects emerging currency markets and contributes to a prolonged monetary policy hiking (increasing interest rates) cycle. This is caused by possible capital outflows as investors shift their assets from emerging markets to "safe-haven."[6]. Emerging market economies strive to protect their currencies by adjusting policy rates to ensure that their assets remain competitive

[4] International Monetary Fund: World Economic Outlook, October 2022: Countering the cost-of-living crisis. Available at: https://www.imf.org/en/Publications/WEO/Issues/2022/10/11/world-economic-outlook-october-2022#:~:text=Inflation%20and% 20uncertainty&text=This%20is%20the%20weakest% 20growth,to%204.1%20percent%20by%202024 (Accessed: 19 May 2023).

[5] Lagged effects refer to response lags or the time it takes for monetary policies to have any impact on a country's economy after being implemented in response to adverse economic events.

[6] A safe-haven currency is a currency that is perceived to have a strong and stable economy behind it and is able to endure unexpected events. These include the US dollar, Japanese yen and the Swiss franc.

in the international markets. Consequently, the longer-than-expected policy hiking cycle in SA has been partly in response to a highly volatile rand exchange rate against major currencies. The rand exchange rate has been highly volatile due to domestic policy, political uncertainty, and unstable global economic conditions associated with the Russia-Ukraine geopolitical conflicts. For instance, the South African rand ***depreciated by more than 26% against major currencies, such as the US dollar, from R15.62 in May 2022 to R19.72 in May 2023***. It, however, recovered some of its losses and traded at an average of ***R18.82 in June 2023.***

The currency weakening could be attributed to numerous factors, including uncertainty about the local political landscape, negative news about SA, and extensive electricity load-shedding, among others (SARB, 2023[7]). The rand depreciated further as the country was placed on the grey list by the Financial Action Task Force (FATF)[8] in February 2023. The accusation by the USA ambassador that SA supplied weapons to Russia in December 2022 ***weakened the rand by about 5% in the second week of May 2023***[9].

3. Interest rate trends in South Africa: pre and post-Covid-19

Figure 1 shows the repo and prime lending rates between January 2019 and March 2023. The repo rate was 6.25% prior to the global pandemic. As the inflation rate dropped significantly amid diminishing demand for consumer goods due to hard lockdown restrictions, the SARB trimmed repo rates to a cumulative ***low of 3.5% from March 2029 to July 2020***. However, as the inflation rate began to rise in the second half of 2021 due to improving demand for consumer goods as lockdown restrictions were gradually lifted, the SARB started to hike its repo rate in November of the same year.

As outlined in the preceding section above, inflation rate accelerated significantly in 2022 due to unfavourable global economic conditions coupled with local structural constraints. This necessitated aggressive monetary policy tightening to contain inflation, and consecutively, SARB increased the repo rate. Thus, the SARB has raised interest rates by approximately ***475 (4.75%)*** cumulative basis points between November 2021 and May 2023, taking ***the nominal repo rate to 8.25%.*** This includes three consecutive 75 basis point hikes leading up to November 2022 and 50 basis points in March and May 2023.

The changes in repo rate imply an equivalent increase in prime lending rate. The prime lending rate is a benchmark interest rate that commercial banks may charge their customers. It is affected by the repo rate, which the SARB

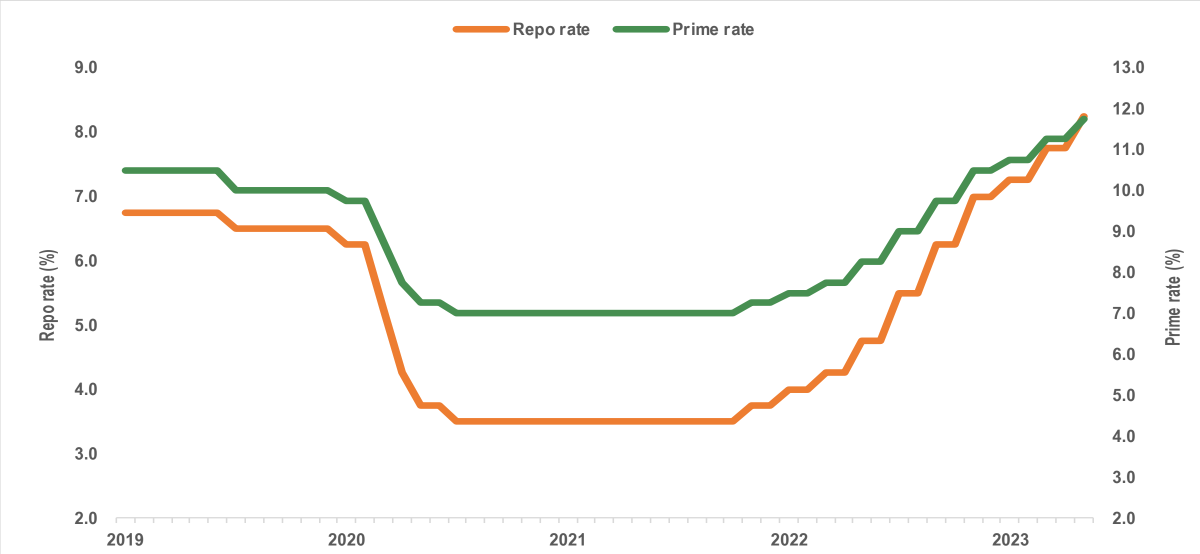
[7] SARB (2023). Monetary Policy Review: April 2023. Retrieved online: https://www.resbank.co.za/content/dam/sarb/publications/monetary-policy-review/2023/Monetary%20Policy%20Review%20April%202023.pdf (Accessed: 19 May 2023).

[8] The Financial Action Task Force (FATF) is the global money laundering and terrorist financing watchdog. It sets international standards that aim to prevent these illegal activities and the harm they cause to society.

[9] The rand was trading at R17.43 on 01 May 2023. It then depreciated to R18.29 on 12 May and peaked at R19.75 on 205 May before recovering to R18.54 on 12 June 2023.

determines. In the current hiking cycle by SARB, ***the prime lending rate has increased from about 7% in October 2021 to 11.75% in May 2023.***

Figure 1: Repo rate and Prime lending rate, January 2019 to May 2023



Source: SARB, 2023

In line with the monetary policy transmission mechanism[10]; adjustments in the repo rate are transferred to the mainstream economy through various channels and have different effects on economic agents[11]. The impact of interest rate changes may take some lags before they can be observed in the entire economy. However, economic agents, especially households and business entities, would be affected by such changes much faster.

4. Impact of increase in interest rates

Credit channel of the monetary policy

While the channels for monetary policy mechanism fall beyond the scope of this article, the credit channel, particularly the balance sheet component, is discussed briefly, given its direct link to households and business entities. Bernanke and Gertler (1989)[12] argued that rising interest rates have adverse effects on a household's balance sheet due to cash flow problems. The decline in household cash flow implies a possible decrease in consumer spending on durable goods and mortgage bonds.

[10] The monetary transmission mechanism is the process by which asset prices and general economic conditions are affected due to monetary policy decisions. Such decisions are intended to influence the aggregate demand, interest rates, and amounts of money and credit in order to affect overall economic performance

[11] Economic agents refer to individuals or entities participating in an economic activity, such as purchasing goods and services.

[12] Bernanke. B & Gertler. M (1989). Agency Costs, Net Worth, and Business Fluctuations. The American Economic Review, Vol. 79, No. 1 (Mar. 1989), pp. 14-31 (18 pages). Retrieved online: https://www.jstor.org/stable/1804770 (Accessed: 11 May 2023).

Also, a decline in a household's cash flow increases the likelihood of financial distress, which reduces their desire to hold durable goods or mortgage bonds. Similarly, from the business entities' perspective, increases in interest rates cause a deterioration in their balance sheets because it reduces cash flow.

4.1 Households

The effects of rising interest rates on households are a double-edged sword because they have positive outcomes for savers and investors but adverse effects on borrowers. However, this article focuses mainly on the latter, as the current hiking cycle could ultimately cause financial distress as interest payments on various financial products are adjusted upward consistently with the prime lending rate increase. The impact of rising interest rates on borrowers may vary with the type of debt, namely, unsecured[13] or secured.

The unsecured debt includes financial products such as retail credit, credit cards and personal loans with higher interest rates as lenders compensate for the increased risk. For instance, the maximum allowable interest rate for a retail credit facility is 17.5% per annum, and most stores already charge this rate on their credit accounts. Thus, the current interest rate increases are unlikely to significantly impact consumers if their interest rate has already reached this maximum allowable level. However, credit providers who were charging less than the maximum allowable interest may opt to increase the interest charged accordingly.

On the other hand, secured debt,[14] such as home loans and vehicle finance, usually have a lower interest rate compared to unsecured debt, given the lower risk. With regards to secured debt, the extent to which changes in interest rates affect consumers depends vastly on their finance agreement, namely fixed or linked interest rate. A fixed interest rate will not change for the duration of the payment period, whilst a linked interest rate is linked to the prime lending rate and fluctuates with the repo rate. If the repo-rate changes, the monthly payment on that particular financial product will also change in line with the prime rate. Linked interest rates are usually slightly lower than fixed. Generally, both financing agreements have unique pros and cons depending on each consumer's preferences.

4.1.1 Secured Debt and interest rate

Vehicle loans

Consumers have the option to choose between fixed and linked-interest rates for their vehicle finance agreement. In respect of fixed interest rates, consumers would not be affected by either a declining or rising repo rate. This implies that consumers whose vehicles are financed through a fixed interest rate continued to pay higher interest

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[13] An unsecured loan has no asset tied to it, which implies a greater risk to the lender.

[14] Secured loans are financial products backed by an asset as security that the borrower will pay back the loan. The collateral attached to the loan makes secured loans less risky, allowing for lower interest rates.

rates during the Covid-19 pandemic when the repo rate dropped to a historically low level. Furthermore, the current hiking cycle will not affect consumers with a fixed interest in their vehicle finance agreement.

In contrast, consumers with linked interest rates on their vehicle finance agreement tend to experience changes in their monthly payments if the repo rate is adjusted. Therefore, the current hiking cycle may have a negative impact on consumers with linked interest rate agreements as their monthly payments also increase

For example, a person with a vehicle loan of R280 000 on a 72-month payment plan was paying approximately R4 863 when the interest rates were low at 7%. However, with the current prime lending rate of 11.75%, the monthly instalment would be R5 530, excluding the deposit and balloon payments. This example clearly shows how the household cash flow is negatively affected by the increase in interest rates – this household would have to pay an additional R667.00 per month for the same debt.

As shown above, the automotive industry is directly impacted by the ongoing increase in interest rates. In this regard, higher interest rates cause vehicle prices to increase, which significantly raises the overall cost of car ownership. According to WesBank, car ownership costs in SA have dramatically increased over the previous ten years, with vehicle instalments being one of the leading causes. As a result, vehicle sales may suffer due to the unpredictability of financing rates. Stats SA reports that compared to the same period in 2022, ***motor trade sales decreased by 2.5% in the first quarter of 2023[15].***

Home loans

Generally, home loans are awarded by default on the basis of the linked interest rates, but consumers can apply for a fixed interest rate once the mortgage bond has been registered. This means that changes in interest rates have serious implications on bond repayment. In respect of the falling interest rates during the Covid-19 era, homeowners gained significant savings as their monthly bond payments dropped significantly. As shown in Table 1, prime lending rate was 10% prior to the pandemic, implying that a homeowner with a bond amount of ***R1 million over 20 years was paying R9 650 monthly.***

Table 1: Monthly home loan instalment repayment

	Decrease in repo-rate: 6.50% to 3.50%			Increase in repo-rate: 3.50% to 8.25%		
	Monthly instalments		Monthly saving from 10% to 7.25%	Monthly instalments		Additional monthly payment from 7.25% to 11.75%
Bond payment	Prime rate: 10%	Prime rate: 7.25%		Prime rate: 7.25%	Prime rate: 11.75%	
R500 000	R4 825	R3 952	R873	R3 952	R5 419	R1 467
R750 000	R7 238	R5 928	R1 310	R5 928	R8 128	R2 200
R1 000 000	R9 650	R7 904	R1 746	R7 904	R10 837	R2 933
R2 000 000	R19 300	R15 808	R3 492	R15 808	R21 674	R5 866
R3 000 000	R28 951	R23 711	R5 240	R23 711	R32 511	R8 800
R4 000 000	R38 601	R31 615	R6 986	R31 615	R43 348	R11 733
R5 000 000	R48 251	R39 519	R8 732	R39 519	R54 185	R14 666

[15] Stats SA (2023). Motor Trade Sales (preliminary): March 2023. Statistical Release: P6343.2. Retrieved online: https://www.statssa.gov.za/publications/P63432/P63 432March2023.pdf.

Source: Own Calculations using data from Better Bonds[16]

Given that the prime rate decreased significantly ***to 7% in July 2020 before increasing slightly by 25 basis points to 7.25% in November 2021***, the monthly payment for this homeowner would have ***dropped to approximately R7 904 during the same period.*** This translates to ***a monthly saving of about R1 764 from a prime rate of 10% to 7.25%.*** Also, low-interest rates during the pandemic induced an increase in new home loan applications, following low and affordable mortgage bond loans. This was evident in a ***dramatic rise in deeds office registrations by a significant 11.47% for the six months ending in November 2021, up from the 8.43% growth*** recorded for the same period in 2020[17].

The current rise in the repo and prime lending rates have a negative impact on monthly bond payments. As shown in Table 1 above, a homeowner with a mortgage bond of R1 million over a period of 20 years was paying about R7 904 in November 2021. The monthly payment on the same mortgage bond loan has increased to around R10 837 at the current prime rate of 11.75%. This implies that their monthly payment has increased by about R2 933 over the past 18 months to May 2023.

The information above suggests that the real estate market is directly impacted by the ongoing increase in interest rates, whereby rising interest rates cause high property prices due to increased borrowing costs. This may constrain property sales due to consumers' concern over increased bond repayment costs. This is supported by the ***FNB House Prices Index (FNB HPI[18]), which dropped to 2.1% year-on-year in the first quarter of 2023,*** the lowest reading since July 2020. Further, a persistent rise in interest rates could lead to homeowners defaulting on their bond repayments, thereby affecting the property market.

The SARB (2023[19]) indicates that household debt-servicing costs climbed to 7.5% of household income, adding further pressure to households in general and those with high levels of debt. Notably, the nominal repo rate has surpassed the pre-pandemic level by a moderate magnitude. As indicated above, the prime lending rate was 10% prior to the global pandemic and recently increased to about 11.75% in May 2023. The current rise in interest rates has reduced the household savings accumulated during the lockdown, as the mortgage bond payments begin to exceed the pre-pandemic levels. This is evident on the FNB property barometer,[20] which shows a decline in

[16] Better Bonds. Available online: https://www.betterbond.co.za/calculators /home-loan-repayment (Accessed: 22 May 2023).

[17] Business Tech. Available online: https://businesstech.co.za/news/ property/571302/should-you-fix-your-mortgage-rate-after-the-latest-rate- hike-in-south-africa/ (Accessed: 19 May 2023).

[18] FNB House Price Index: each house price in any month's sample is compared with its own previous transaction value. The various price inflation rates of individual homes are then utilised to compile the average price inflation rate of the index over time.

[19] SARB (2023). Quarterly Bulletin: March 2023. Retrieved online: https://www.resbank.co.za/content/dam/sarb/publications/quarterly- bulletins/quarterly-bulletin-publications/2023/01Full%20Quarterly%20Bulletin.pdf (Accessed: 19 May 2023).

[20] FNB Property Barometer. April 2023. Retrieved online: https://www.fnb.co.za/downloads/economics/reports/2023/propertyBarometerApril.pdf.

household balance sheet strength[21]. This implies that households are left with limited buffers to weather the economic downturn.

4.2 Businesses

As indicated above, changes in the interest rate may have positive and negative effects on businesses. For instance, low-interest rates are believed to positively affect businesses as they improve cash flow, thereby allowing businesses to invest in other growth assets. Notably, low-interest rates also increase household demand for consumer goods and services, which supports businesses' profitability.

In contrast, rising interest rates negatively affect businesses as it reduces their profitability. This is because the cost of capital needed to take on expansion initiatives becomes higher. As a result, businesses are unable to take on growth projects, thus curtailing businesses' attempts at growth and limiting new hiring and job creation. Small, Medium and Micro Enterprises (SMMEs) are particularly vulnerable to changing economic conditions and consumer demand due to their lack of resources, mainly depending on loan funds to run their operations. Hikes in interest rates make it more expensive for SMMEs to take loans to carry out their day-to-day business activities and undertake expansion projects. Additionally, SMEs suffer more when the SARB implements rate hikes because, in contrast to large corporations, they cannot access capital through the equity markets as an alternative to loans from commercial banks.

The impact of increased interest rates on the economy is, therefore, through the reduction in productivity and output by businesses which is induced by increased borrowing costs and the decline in spending and demand by households. Another impact on employment happens because higher interest rates result in a higher cost of consumer borrowing which causes a drop in demand for goods and services. As a result, firms are forced to reduce production and labour, which could raise unemployment.

5. Concluding remarks

The primary purpose of this article was to discuss the SARB's monetary policy stance during and after Covid-19 and how it has affected consumers, businesses, and the economy. The SARB lowered the repo rate to a level not seen in a long time in response to the economic shock caused by the Covid-19 crisis. However, as the economy started recovering again in 2021, prices rocketed, forcing the SARB to change its monetary policy in order to fight inflation. The SARB consequently started raising the repo rate.

South Africans ' cost of living is rising partly because of the repo rate and the subsequent increase in the prime lending rate. These interest rate increases are passed on to the economy through the rising cost of borrowing. Due

[21] Household net wealth - the value of household assets minus outstanding liabilities.

to this increased cost of borrowing from the SARB, commercial banks have to raise their interest rates on financial products offered to consumers and businesses.

As a result, businesses and consumers are less inclined to borrow money from banks. Furthermore, businesses are forced to reduce production and labour due to a decline in consumer demand for goods and services, which pushes up the unemployment rate and slows the economy. Despite the slowing inflation rate, the SARB is anticipated to increase the repo rate further to achieve a low and steady interest rate.