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The Effect Of High Interest Rates On Your Debt vs Savings



Interest rates play a crucial role in the financial world, affecting both borrowers and savers. People are generally not open to the idea of rising interest rates, especially in an economy like South Africa where they are constantly being hiked to cool down inflation. This is primarily attributed to the fact that a significant portion of the South African population is grappling with overwhelming debt.

On the contrary, interest rate hikes are welcomed by the minority who actively save. When interest rates are high, it can have significant implications for individuals managing debt and those trying to grow their savings. Below, we will explore the different impacts of high-interest rates on both debt and savings.

Debt

Let's begin by examining the impact of high-interest rates on debt. In certain situations, paying for expenses in cash can prove burdensome, prompting individuals to resort to debt in the form of mortgages, loans, credit cards, or auto loans. The lender and borrower come to an agreement regarding the interest rate that will be applied to repay the borrowed amount. High-interest rates mean that you will incur more substantial interest charges over time, increasing the total cost of your debt. This can make it more challenging to repay your loans, as a larger portion of your payments will go toward interest rather than reducing the principal balance.

When interest rates are hiked this leads to an increase in the repo rate which ultimately means your lending rate will also increase. For example, suppose you have a R100 000 credit card balance with an annual interest rate of 20%. This means that your monthly minimum payments would be R20 000. However, if the interest rates increase and the lending rate rises to 25% per year, your monthly payments would then become R25 000. This means it can take years to pay off the debt due to the compounding effect of high-interest charges. Not only does this prolong your financial burden, but it also means you'll pay significantly more in interest over time.

Furthermore, high-interest rates on debt can make it more difficult to qualify for new loans or lines of credit. Lenders are more cautious when interest rates are high, as they are concerned about the borrower's ability to make payments. This can limit your financial flexibility and make it challenging to access credit when needed.

When it comes to home loans, you have the option to select either a fixed rate or a flexible rate. A fixed rate remains unchanged over the entire duration of the loan, while a flexible rate fluctuates in response to shifts in interest rates. However, it's important to note that the fixed rate expires after the initial agreement. At that point, you can either choose to switch to the flexible interest rates or negotiate a new fixed rate with the bank.

Savings

On the other hand, high-interest rates can have a positive effect on savings. When you deposit money into a savings account, interest income investments or invest in fixed-income instruments such as certificates of deposit (CDs) or government bonds, higher interest rates mean that your savings will grow more quickly over time. This can be advantageous for individuals looking to build an emergency fund, save for a specific goal, or plan for retirement.

For instance, if you deposit R100 000 into a savings account with an annual interest rate of 5%, your savings will generate an additional R5 000. However, in a scenario

where interest rates are increased to 6.75% per annum, your interest income will rise to R6 750. It's important to note that in a higher rate environment, you will earn more interest compared to a lower rate environment. Over time, compounding can significantly boost your savings, allowing you to reach your financial goals sooner. However, it's essential to note that high-interest rates on savings are not always guaranteed. Interest rates are influenced by various factors, including central bank policies, inflation, and economic conditions. They can fluctuate over time, and it's crucial to consider the overall interest rate environment when making financial decisions.

The latest interest hike was on the 30 March 2023, when the South African Reserve Bank's Monetary Policy Committee made the decision to raise interest rates in the country by 50 basis points. The adjustment brought the repurchase rate to 7.75% and the prime lending rate to 11.25%. According to The South African, with this recent rate hike, the total increase since November 2021 amounts to 425 basis points. Considering a new home loan of R2 million at the 'prime' rate, this latest increase translates to an approximate monthly instalment rise of R680. Since November 2021, monthly payments on a R2 million home loan have become nearly R5 500 more expensive. It's worth noting that these rates currently stand at their highest level in 13 years, dating back to June 2009 when the local currency was impacted by the global financial crisis.

To navigate the effects of high-interest rates on debt and savings, it's essential to adopt sound financial strategies. If you have debt, focus on paying it off as quickly as possible to minimise the impact of compounding interest. Consider making larger payments or exploring debt consolidation options with lower interest rates. For savers, take advantage of high-interest rate environments by researching and comparing savings accounts or investment options that offer competitive rates. Diversify your savings by exploring different investment vehicles, such as stocks or mutual funds, that can potentially provide higher returns over the long term.

Lastly, consult with a financial advisor who can provide personalised guidance based on your specific financial situation. They can help you develop a comprehensive plan to manage your debt, grow your savings, and adapt to changing interest rate environments.

In conclusion, high interest rates can have contrasting effects on debt and savings.

While they make it more challenging to manage debt by increasing interest costs, they can also accelerate savings growth. By understanding these dynamics and implementing effective financial strategies, individuals can navigate the impact of high-interest rates and work towards achieving their financial goals.



Sandra Munzara
Technical Analyst

Sandra joined Global and Local in May 2021 as a technical analyst and since then she has been diligent in applying her skills in the various tasks performed by the Technical department.

Sandra holds a bachelor’s degree in finance, a BCom Honours degree in Financial Planning, a CFI excel course certificate and an RE5 certificate.

During her spare time, she enjoys swimming, and playing chess. watching classic movies.

Contact Us

Global & Local
The Investment Experts

18th Floor Metalbox, 25 Owl Street,
Auckland Park, Johannesburg, 2092

T | +27 11 486 2500

info@globallocal.co.za
www.globallocal.co.za

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