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FINANCIAL SERVICES

What do low interest rates mean for the luxury industry?

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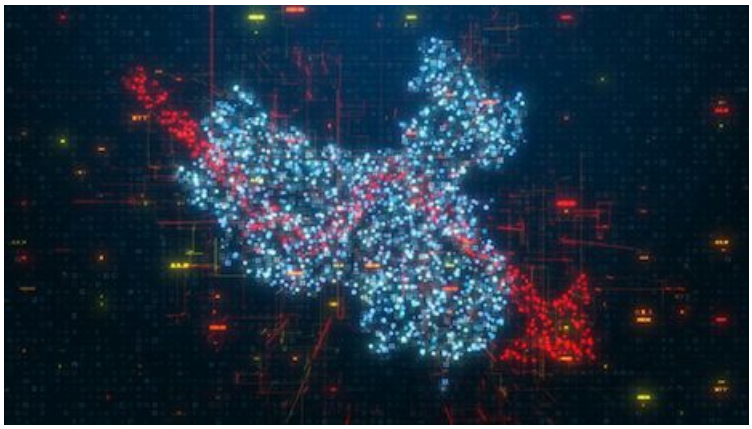

Low interest rates boost consumer confidence and even help the luxury industry because they give middle-market consumers more disposable income to spend. Image credit: Shutterstock

By Adina-Laura Achim

Central banks around the world are keeping their interest rates at ultra-low levels, and we forecast that President-elect Joe Biden will continue on this path as he tries to revive the economy.

As a general rule, low interest rates boost consumer confidence and have a positive impact on small to midsized enterprises (SME), borrowing companies and even businesses operating in the luxury industry because they give middle-market consumers more disposable income to spend on luxury purchases.

In 2019, before the pandemic hit the United States, almost 30 percent of U.S.-based SMEs reported having no outstanding debt. However, 70 percent of small businesses actually did have outstanding debt. The situation turned even grimmer in 2020 after pandemic-related challenges arose.

"Small businesses constitute more than 90 percent of the global private sector, providing 70 percent of all jobs, and drive half the global economy," according to The Center for Strategic and International Studies (CSIS). And the apparel and fashion industries depend on SMEs to offer "a vital source of employment and growth in the industry," says the International Labor Organization (ILO).

But because of store closures and a drop in demand, SMEs had to cut production, sending an unprecedented number of workers into unemployment.

The ILO estimates that somewhere between 440,000 to 880,000 workers in Vietnam could face reduced hours or unemployment. In an extreme case, this figure could grow to 1.3 million workers. And in Myanmar, the lack of raw materials from China has significantly contributed to manufacturing decline and the closure of at least 20 factories.

But the economic outlook in advanced economies is not significantly better.

"Based on current positions for earnings before interest, taxes, depreciation and amortization (EBITDA), 75 percent of publicly listed apparel and fashion companies in North America could find themselves with negative EBITDA or untenable net debt-to-EBITDA ratios after three-month store closures," says McKinsey & Co.

The severe socio-economic implications of COVID-19 have pushed governments around the world to come up with stimulus plans that could protect jobs and restart economies. In this context, keeping interest rates at low levels seems like a viable solution.

In April, China cut its benchmark lending rate for the second time this year to help jumpstart the economy.

"The one-year loan prime rate (LPR) CNYLPR1Y=CFXS was lowered by 20 basis points (bps) to 3.85 percent from 4.05 percent previously, while the five-year LPR CNYLPR5Y=CFXS was cut by 10 bps to 4.65 percent from 4.75 percent," Reuters reported.

Moreover, China has taken unprecedented steps in limiting disruptions from the pandemic and protecting SMEs from liquidity shortages. Nevertheless, an extended period of ultra-low interest rates could have some troublesome consequences.

For example, banks are tightening lending standards to protect against loan losses, as they expect risky borrowers to go out of business. That could curb borrowing and leave SMEs in financial distress.

But SMEs that operate with limited cash flow are not the only ones sensitive to interest rates. In fact, even the expansion of ecommerce players and big retailers depends on interest rates.

Generally speaking, keeping rates at ultra-low levels translates into low earnings on bank deposits and savings, which means investors must reserve higher contributions to manage their portfolios and meet their investment objectives. And while low interest rates should encourage research and development, innovation strategies, and investments in new technologies, that is not always the case.

In August, China's central bank warned of the risks of ultra-low interest rates in Western nations for the global economy, cautioning that they could lead to spill-over effects for other countries.

With inflation levels having stayed below target for a long time, "low interest rates implemented in developed economies haven't reached the desired effects," said the People's Bank of China in its quarterly monetary policy report.

According to PBOC, low interest rates have weakened bank profit and caused a credit crunch in some circumstances. The report also highlights that low interest rates could speed up "debt growth and overcapacity problems in the corporate sector."

The Financial Post says that traditional bricks-and-mortar industries have lost their competitive advantage in a low interest rate environment.

"Low interest rates have lowered the cost of capital dramatically, while new technology has allowed for instant scaling among already established networks," it states. "As a result, tech-based companies can run their businesses at a loss as long as they have access to inexpensive capital to fund rapid growth of recurring revenues."

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