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The Impact of Interest Rate Changes on Consumer Spending

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ABSTRACT
This research was justified by the need to establish the impact of shifts in interest rates on consumption expenditures, which is a key factor in economic growth. Thus, the research's objectives are to explore the influence of monetary policy actions performed by central banks in the context of their impact on consumers. It makes it possible for any given policymaker to work out measures which are favourable for both economic growth and stability. Further, these insights are useful in deciding the future business strategy since they give the companies an idea of what to expect in the market. In general, the study aims at expanding the existing knowledge concerning the macroeconomic consequences of interest rate volatility.

Chapter 1: Introduction

1.1 Research Background

Interest rates are considered an essential determinant employed by central banks to foster and regulate economic activity, especially concerning the expenditure of consumers (Gafurdjan, 2024). Cheaper credit rates mean that the consumers will be able to afford loans for big transactions such as the acquisition of houses and cars, thereby increasing expenditure. On the other hand, high rates have the effect of raising the cost of borrowing, thus discouraging credit to consumers and thus spending. Its conceptual foundation is based on the frameworks of both classical and Keynesian economics concerning the influence of interest rates and total demand for output and economic growth (Coibion et al. 2020). Traditionally, monetary policies involved matters such as the lowering of the interest rates by central banks such as the Fed or ECB to manage inflation and ensure the economy balances out. Fluctuations in interest rates have implications not only in the cost of credit but also on disposable income since they determine the amount of mortgage repayments and returns on savings, all of which play a role in consumer sentiments and spending behaviour. It is important for policymakers who would wish to ensure that there is balance in the economy and rates persistently.

1.2 Research Rationale

This research was justified by the need to establish the impact of shifts in interest rates on consumption expenditures, which is a key factor in economic growth. Thus, the research's objectives are to explore the influence of monetary policy actions performed by central banks in the context of their impact on consumers. It makes it possible for any given policymaker to work out measures which are favourable for both economic growth and stability. Further, these insights are useful in deciding the future business strategy since they give the companies an idea of what to expect in the market. In general, the study aims at expanding the existing knowledge concerning the macroeconomic consequences of interest rate volatility.

1.3 Research Objective

- To analyse the impact of interest rate changes on consumer spending patterns across different economic sectors.
- To evaluate the short-term and long-term effects of interest rate fluctuations on consumer confidence and purchasing behaviour.
- To assess the role of interest rate changes in influencing major consumer expenditures, such as housing, automobiles, and durable goods.

1.4 Research Question

1. How do interest rate changes impact consumer spending patterns across various economic sectors?
2. What are the short-term and long-term effects of interest rate fluctuations on consumer confidence and major expenditures like housing and automobiles?

1.5 Research Gap

Despite studies involving interest rates and their relation to consumption, the analysis of specific rates on various sectors of the economy and the temporal variations in the effects on consumption are still lacking. Previous works have generalised the connection, without consideration for urgent sector susceptibilities or fluctuations in consumer optimism. Furthermore, the adjustment of interest rates impacts other major consumer spending categories, including housing and automobiles, and this aspect is not well addressed. These research questions seek to address these gaps by offering a clearer and more comprehensive analysis of how interest rate movements impact different segments and big expenditure decisions on behalf of the key academic contributions that this paper brings.

1.6 Chapter Summary

This section examines how interest rates impact consumer spending. It discusses how central banks change interest rates to control the level of economic activity and to control loans on big purchases such as buying a house or car. The main aim of the research is to examine the potential impacts of interest rate changes on consumer spending patterns in the various economic sectors, and both short-term and long-term impacts on consumer confidence, and purchasing behaviour (Agarwal et al. 2023). Previous research has been identified, though there are gaps, particularly in terms of sector-specific effects and temporal variations. This study aims to fill the gaps in the literature providing significant implications for policymakers and firms regarding the macroeconomic consequences that would result from interest rate volatility.

Chapter 2: Literature Review

2.1 Theme 1: The Relationship Between Interest Rates and Consumer Spending Patterns

As per Bachas et al. (2020), in the world of monetary policy, interest rates act as an important player in constructing consumer spending trends as well as to aid in shaping the current economy. This topic develops the theory of how interest rate shifts directly affect consumer spending habits using observational evidence. Economic theories that have been designed over the years by Classical and Keynesian economists provide the basis needed to grasp how interest rate shifts affect the overall demand of an economy. Lower interest rates will usually decrease the amount most Americans will have to pay for borrowing, luring them into loans to buy homes, cars, and other long-lasting goods.

The result of this augmentation in consumer spending is a boost to economic growth. However, Coibion et al. (2024) stated that a rise in interest rates increases the cost of borrowing, and consumer loans, as well as spending, could fall, thereby possibly dampening economic activity. Test results have made it

clear that movements in interest rates systematically influence consumer confidence and perspective. Given low rates of interest, consumers are more hopeful and apt to spend in larger quantities, while high interest rates can cause a drop in disposable income and growth in savings putting a damper on economic spending.

2.2 Theme 2: Short-Term and Long-Term Effects of Interest Rate Fluctuations on Consumer Confidence and Major Expenditures

This topic goes into the effects of interest rates. Things that affect consumer confidence, especially in larger purchases like houses and cars. Things that immediately affect consumers that immediately affect how things look. Also short and long-term effects

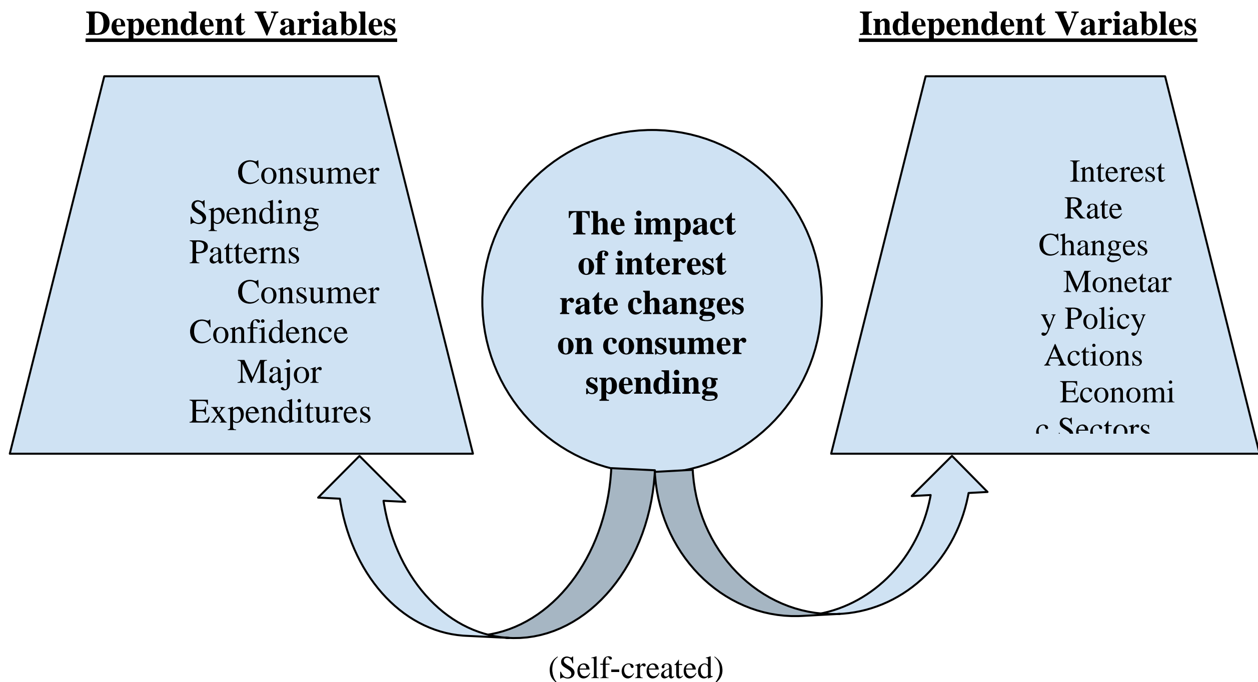
Alternatively, Hasan et al. (2022), higher interest rates can quickly cool consumer enthusiasm, leading to lower spending and higher saving rates. Longer-term effects are harder to determine and are more multidimensional: intense and protracted low-interest-rate environments can increase household debt as borrowers take on cheap credit, making the debt pile's service look more alarming if economic conditions sour. Conversely, Kozlov, (2023) stated that, rates held high for a prolonged time could mean long stretches of low spending and stagnating economies.

While considering the relationship, the literature speaks at length regarding the significance of consumer confidence to be a mediating factor of the relationship. Future expectations of economic conditions are highly capable in shaping consumers' responses to changes in interest rates. It is important to understand these effects to keep economic growth and stability.

2.3 Theoretical Framework

The conceptual structure for this study is constituted of traditionally recognized theories of economics the Classical and Keynesian economic theories. This framework considers how these theories correspond with consumer spending in terms of interest rates. To illustrate, the classical economy posits that lower the interest rate higher the consumer spending as loans become more beneficial for consumers to borrow. This notion is indirectly supported by Keynesian theory, which suggests that the potential aggression of aggregate demand can be manipulated through interest rates, which could shape the economy accordingly. The framework also addresses consumer confidence where it tends to play a mediating role between changes of interest rates and consumer spending. In particular, lower interest rates usually push self-confidence to boost spending and vice versa. Finally, a sector-specific feature of the changes in interest rates will complete this framework. It can be seen that the influence of the change in interest rates depends on which financial area one might be looking at. As for housing prices or auto prices, the audience is likely to expect some changes in the interest rate as what happened in the 20 % process.

2.4 Conceptual Framework



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2.5 Literature Gap

Despite much research being done on the connection between interest rates and the spending activity of consumers, many gaps remain. Many of the prior studies have looked at interest rates as a whole and have not examined industry-specific effects or temporal variations. The impact of interest rates is only roughly estimated and the extent of interest rate change that impacts consumer confidence and sector spending, including spending in the house and automobile markets is unrevealed. The long-term effects of interest rate fluctuations on consumer spending on major consumption such as house and automobile, have not been well investigated either. The paper is created with the final objective of effectively closing these gaps in knowledge by investigating which sectors effectively respond to interest rate change and therefore providing more reliable information to businesses and policymakers.

Chapter 3: Methodology

3.1 Research Philosophy

This research is grounded in a constructivist worldview, one that argues reality to be socially constructed and subjective, focusing on the meanings individuals attach to their experiences (Ruggiano and Perry, 2019). Using qualitative data drawn from secondary sources, the study aspires to depict the several faceted effects of interest rate changes on consumer spending through the examination of existing research, reports, and economic analyses.

3.2 Research Approach

An inductive approach is used in this research, which is suitable for exploratory and descriptive studies. Induction involves collecting specific qualitative information and then identifying patterns, themes, and solutions. Because it does not include any preceding hypothetical hypothesis, this approach is effective for a further understanding of what are the effects of interest rate fluctuations on consumer behaviour and confidence (Taherdoost, 2022). Any proof is directly obtained from the data, enabling the findings to be fully developed and contextually driven.

3.3 Research Strategy

This study utilises a descriptive research approach to methodically depict how the shift in interest rates links with the spending activities of customers. Employing the method is fitting for determining the intricacies and dissimilarities of customers' actions to the fluctuations in the economy between various commercial divisions (Ma et al. 2020). By critically reviewing primary information sources such as academic papers, trade journals, government documents, and business appraisals, the report will summarise the literature on the focal subject, encompass a global perspective and highlight the leading progressions.

3.4 Research Choices

This study is exclusively qualitative, which fits ideally with the research questions as they are exploratory. Qualitative research offers a more detailed and in-depth analysis of secondary data, providing a greater understanding of the underlying mechanisms and contextual factors that drive consumer spending in response to interest rate shifts (Brandao-Marques et al. 2021). The qualitative method it will be using ensures that the research philosophy and approach is congruent, which allows for the research topic to be explored thoroughly and cohesively.

3.5 Data Collection

All the data necessary for this study is taken exclusively from secondary sources. These sources consist of academic articles reviewed by different people in the same field of study, economic reports published by central banks and economic organisations, industry analysis published by Bloomberg and Dow Jones' Financial Times, and economics and bears constructed by the government. These sources are used to compile data together thus creating a detailed explanation of how interest rate changes impact consumer spending (Kiley, 2020). The richness of the secondary data allows for greater awareness of the economic background as a whole, and individual analysis of every sector. This ensures efficiency in its analyses and permits the writer to allow a broad sweep of issues to be brought up before drawing meaningful conclusions based on existing knowledge as it relates to interest rates and consumer behaviour.

Chapter 4: Data Analysis

a. How do interest rate changes impact consumer spending patterns across various economic sectors?

Interest rates, set by central banks, play a crucial role in regulating economic activity, particularly in shaping consumer spending patterns (Dräger and Lamla, 2024). When interest rates change, the cost of borrowing and the returns on savings are affected, which in turn influences consumer behaviour across different economic sectors. Understanding this dynamic is essential for policymakers, businesses, and consumers alike.

Chart 1 (Mauritius Consumer Spending)

Source: (Macrotrends 2024)

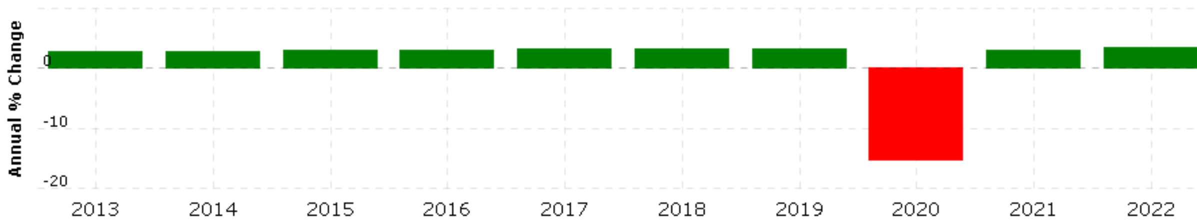

Chart 2 (Mauritius Consumer Spending- Annual % change)

Source: (Macrotrends 2024)

General Impact of Interest Rates on Consumer Spending

The primary ways consumer spending is impacted by interest rates are through both the cost of borrowing and the disposable income. Decreased interest rates reduce the cost of borrowing, making loans for major purchases such as homes, cars and other durable goods more affordable. As a result of this consumers will spend more (Murungi and Okiro, 2018). On the other hand, when interest rates may rise borrowing costs goes up, which deters borrowing and over major purchases then lowers expenditure. In addition, disposable income is affected by interest rates. When interest rates are lower, mortgage payments and other costs of servicing the debt decrease, resulting in consumers having more money to spend on goods and services. When rates are higher, costs increase, disposable income decreases and hence, consumer expenditure (Maital and Barzani, 2020).

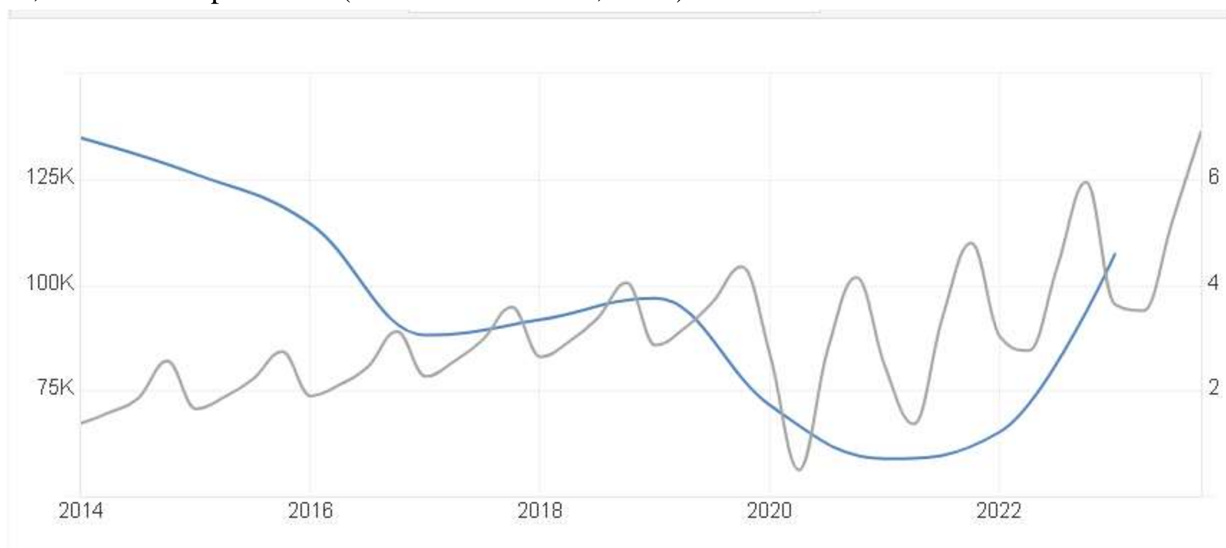

Chart 3 (Comparison of Consumer spending and interest rate)

Source: (TRADING ECONOMICS, 2024)

Impact on the Housing Sector

According to Asamoah et al. (2019), The mortgage industry may be primarily influenced by interest rates. Mortgage rates may decrease as interest rates decrease. Consequently, home loans become more easily distributed. More home loans being attainable implies there will be more homebuyers. Subsequently, the housing market will take off. Once the housing market has profited so do; construction, home-improvement, and real estate representation. Conversely, as mortgage rates ascend, less and less would-be homebuyers can pay, meaning the pace of home sales is liable to slacken. The weakened appetite can ripple throughout related industries, sometimes devolving into a drop in construction and real estate operations.

Impact on the Automotive Sector

Kiley, (2020), stated that the auto industry also sees a large correlation with rising and falling interest rates. As interest rates decrease, auto loans become more affordable due to the drop-in consumer lending rates. This not only makes it easier for consumers to buy new cars but pushes consumer demand for autos up since cars bought on credit are now cheaper to pay back. As a result, the auto sector thrives with sales of new cars increasing, and the subsequent demand in auto parts and related services also increasing.

Impact on Retail and Durable Goods

According to Heider et al. (2021), the ways in which consumer spending is influenced by interest rates is both complex and simple. The simple way is shown first in the durable goods or those retail goods that tend to have a long life. These goods include appliances, electronic equipment, and cars. By lowering the cost of consumer credit, lower interest rates help harmonize the financing of purchases of durable goods, meaning it becomes easier for them to be sold. Hence, there tends to be a higher output of sales for these products when this change is made.

Impact on Consumer Confidence

As per Taylor, (2019), consumer confidence is influenced by changes in interest rates, and it also influences spending behaviour. If interest rates drop, consumer confidence is uplifted because borrowing becomes cheaper, thus consumer spending is encouraged by the rise in disposable income. When consumers see that they can afford to make purchases, necessary and unnecessary items will then have equal chances of being bought. If interest rates surge, consumer confidence will diminish because borrowing becomes more expensive and disposal of income will reduce (Gafurdjanov, 2024). With less confidence, consumers will eventually cut back on spending, especially for unnecessary items.

b. What are the short-term and long-term effects of interest rate fluctuations on consumer confidence and major expenditures like housing and automobiles?

Consumer sentiment and key purchases, such as housing and autos, are easily influenced by movements in interest rates (Coibion et al. 2020). The results, though, are only evident in the immediate and extended run, influencing buying, spending and the economy's overall health in distinctly different manners.

Short-Term Effects

Consumer Confidence

Immediate changes in consumer sentiment can occur as a consequence of changes in prevailing interest rates (Cox et al. 2020). Consumer attitude often rises if rates fall; the financing of debt at lower rates increases, reducing the price of borrowing. The increased belief consumers have in their financial future leads their willingness to make big-ticket goods and discretionary buys to increase. This boom of confidence is critical in that increased consumer debt contributes to growth in the wider economy on top of all manner of major expenditures.

By contrast, increases in rates will easily erode client confidence. When the fees of debt increase, new lending is often diverted from the routine course, which contributes to producing high-cost loans. Not appropriate for significant purchases (Agarwal et al. 2023). This caution is expressed in wider local retail marketing-specific valuations and consumer-driven by more sluggish results.

Housing

In the housing sector, short-term reductions in interest rates can cause mortgage applications and home purchases to immediately skyrocket. When mortgage rates are lower, buying a home becomes more

affordable, leading more consumers to enter the real estate market (Taylor, 2019). That additional demand can drive up home prices and jump-start related industries, such as construction and home improvement.

On the other hand, when interest rates rise, mortgage applications and home purchasing activity immediately dip. Higher mortgage rates make home loans more expensive, so it costs consumers more to buy homes. That can cause the housing market to slow, home prices to fall, and activity in related industries to slow down.

Automobiles

The same short-term dynamics occur in the auto sector. When interest rates fall, the cost of auto loans declines and it becomes more tempting for people to buy a new vehicle. In consequence, a spike in auto sales occurs, perversely benefiting manufacturers, dealers and many other companies that support them. "Zero interests" lends are especially seductive and therefore stimulate sales.

Conversely, when interest rates come up, the cost of buying a car on credit gets more costly and auto sales fall instantly. People will postpone or defect from the purchase of a new vehicle because the monthly carrying costs rise by levels never considered when rates were lower. This, in turn, can kneecap the automotive industry and upend its supply chain.

Long-Term Effects

Consumer Confidence

Over time, alterations in interest rates can have far-reaching repercussions on consumer confidence. Extended periods of low interest rates can encourage amplified household debts as consumers capitalise on the inexpensive credit that is available. Though this can inflate spending in the short-term, it can lead to financial instability should economic conditions decline or consumers overstretch their credit limits.

On the other hand, extensive high interest rates can prompt enduring decreases in consumer confidence. When the costs of borrowing are higher for an extended duration of time it can discourage consumers to acquire additional debt therefore lowering overall consumption and bringing the economy to deadlock. Lengthy spells of high rates can for example encourage amplified savings rates that can benefit individual financial stability, but it can diminish individual spending and decrease overall economic growth in the process.

Chapter 5: Result

Results show that altering interest levels has powerful consequences on the purchasing behaviours of users in numerous divisions of the economy. Consequences of such shifts are immediate in certain scenarios; for instance, if interest rates are reduced, confidence rises, leading to high spending on items costing substantial sums (vehicles and homes) because financing has become less expensive - these drives businesses linked to construct and auto parts to flourish employing users' spending more on this type of items. By comparison, if the interest rates rise, and consumer confidence drops as a result, the spending on big-ticket items such as homes and cars drops instantly, and so this causes a slowdown in the sectors related.

Deposit interest rates in Mauritius have soared from 0.71% in 2021 to 4.58% now. These steeper interest rates are forecasted to lower consumer spending due to more expensive borrowing costs, a tendency to save more money, and a smaller wealth effect. Expensive interest rates dissuade shoppers from acquiring loans for significant acquisitions, which means they have fewer funds to spend right away. Less discretionary spending may also result from a perceived contraction in wealth. At length, the heightened

interest rates in Mauritius may have a hand in decelerating economic expansion, which could cripple business activity and investment.

Over time, ongoing affordable rates encourage consumers to borrow at higher rates – leading to more household debt – as they exploit his or her ability. The possibility of economic instability is enhanced when economic conditions deteriorate. For a longer period of time, high interest rates suppress consumer confidence. Expectations for borrowing fall, total consumption falls and economic invisibility increases. A maximum decrease or increase is affected by most borrowers of debt.

Chapter 6: Conclusion and Recommendation

Changes in interest rates have a strong impact on consumer spending. Important items such as housing and autos are very interest-sensitive, which means they respond more than proportionately to changes in current interest rates. Lowering interest rates boosts spending by reducing borrowing costs. By contrast, higher rates discourage spending, because taking a loan becomes more expensive. In the short run, these effects can change consumer behaviour quickly. In the long run they can lead to higher rates of debt or to economic stagnation. Policymakers must carefully control interest rates to optimise economic growth and stability.

Recommendation

1. **Monitor Interest Rates:** Central banks should regularly review and adjust interest rates to prevent economic bubbles and maintain consumer confidence.
2. **Provide Clear Guidance:** Policymakers should communicate interest rate changes and their implications clearly to help consumers and businesses make informed decisions.
3. **Support Financial Education:** Encourage financial literacy programs to help consumers understand the effects of interest rate changes on their spending and borrowing.
4. **Sector-Specific Policies:** Develop tailored policies to address the unique impacts of interest rate changes on different economic sectors, especially housing and automotive.

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