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Think Strategically: "Navigating Economic Waters: The Consequences of a 10% Prime Rate"

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A Historical Background of the Prime Rate

The prime rate, often considered the benchmark for lending rates, is pivotal in the financial landscape. Entrepreneurs, as key drivers of economic growth, are susceptible to changes in this rate. The historical evolution of the prime rate as a key benchmark interest rate serves as a reference point for many types of loans and is closely related to economic conditions and monetary policy.
During its early origins in the 18th century, the concept of the Prime Rate was developed, but it wasn't formalized until the 20th century. Banks would set their base lending rates as a reference for other loans.

These lending rates would be the norm until the Federal Reserve Act of 1913; as the U.S. established the Federal Reserve System, the Fed bank became more active in influencing interest rates. The original Federal Reserve Act authorized the Fed to set the "discount rate" at which member banks could borrow from the central bank. While not the same as the prime rate, it laid the foundation for the Fed's.

During the Great Depression Era from 1929-1939, the U.S. government and the Federal Reserve implemented policies to stabilize the economy, interest rates were actively managed, and the concept of a "prime rate" emerged as a benchmark rate for commercial loans.
From the 1950s to the 1960s, the prime rate became formalized and widely recognized as the benchmark interest rate for banks. Money Center banks such as Citi or JP Morgan Chase typically set it based on their costs of funds. However, broader economic conditions and the actions of the Federal Reserve influenced it.

As the decades passed and with diverse economic conditions, the Prim Rate rose to as high as 21.5% in 1980 as the economy dealt with a period of high inflation. When I became a commercial banker in 1987, most loans in their loan agreement had a clause stating, **"This commercial loan shall bear interest at a rate determined by reference to the prime rate as established by Citibank NA in New York. The interest rate shall be calculated as the prime rate plus a margin of xx percentage points."** The prime rate is closely tied to economic developments, monetary policy, and the broader financial landscape.

The Challenges of a Prime Rate of 10% or higher

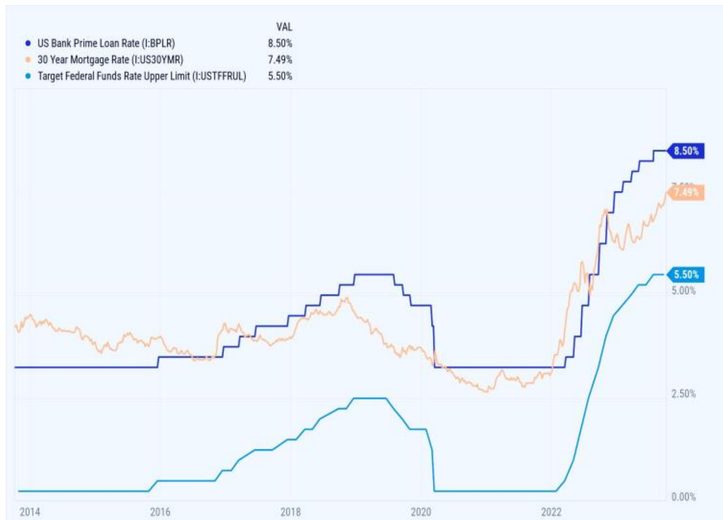
A significant rise in the prime rate, above 10%, can have multifaceted impacts on entrepreneurs, their businesses, and the overall economy. Our analysis explores the nuanced consequences across various economic dimensions. Considering that as the Consumer Price Index reached 7.87% in February of 2022 or 293.5% above the Fed's inflation target rate of 2%, the Fed, who had until then called inflation temporary, would begin increasing rates on March 17, 2022, by 25 basis points increasing rates 11 times and taking the Fed Funds rate by July 29, 2023, to 5.50%. Simultaneously, the Prime Rate rose from 3.50% to 8.50% in the same period, a 142.85% increase.

Interest Costs for Entrepreneurs

Most Entrepreneurs and businesses rely on borrowed capital to fund their operations, expansions, and investments. The prime rate is the reference point for most variable-rate loans, directly impacting entrepreneurs' borrowing costs.

Consider a manufacturing business with a $5 million variable-rate loan tied to the prime rate. As the prime rate escalated from 3.50% to 8.50%, this business's annual interest expenses rose from $175,000 to $425,000 or $250,000, exerting substantial pressure on its cash flow and profitability. Should the Prime Rate rise to 10%, the annual interest payments would be $500,000.

US Bank Prime Rate, 30-Year Mortgage Rate vs Fed Funds Rate



Bankruptcies Will Rise

The relationship between increasing interest rates and business bankruptcies is well-documented. As the prime rate climbs, businesses face increased debt servicing costs, particularly those with high debt levels.

The historical data shows that for every 1% increase in the prime rate, bankruptcy filings among small businesses rise by approximately 10%. Thus, a prime rate ascent from 5% to 10% could potentially result in a 50% surge in small business bankruptcies.

The bankruptcy domino effect affects suppliers and service providers, causing a ripple effect throughout supply chains.

GDP Growth Impacted

The Gross Domestic Product (GDP) is a vital indicator of a nation's economic health. Entrepreneurs drive economic growth through innovation, job creation, and capital investment.

Some economic models suggest that a 2% increase in the prime rate could translate to a 1% decrease in annual GDP growth. Consequently, a prime rate shift from 5% to 10% might lead to a potential 2.5% reduction in GDP growth. However, these scenarios have not materialized as the US GDP forecast for 2023 is 2.2%, and the latest GDPNow for the third quarter is 4.90%.

Date	GDPNow 3Q23	Change
7/28/23	3.50%	Initial Forecast
8/31/23	5.60%	37.5%
9/29/23	4.90%	-14.3%
10/2/23	4.90%	0.0%
10/5/23	4.90%	0.0%

The Labor Market is a Critical Piece

A robust labor market is vital for sustained economic growth and social stability. However, higher interest rates can ripple effect on the labor market. Most research indicates that a 1% increase in interest rates can lead to a 0.5% decrease in job creation.

Thus, with a prime rate hike from 5% to 10%, we could observe a 2.5% reduction in new job openings as entrepreneurs become more cautious about hiring additional employees. Others may resort to cost-cutting measures and layoffs to mitigate the costs, resulting in higher unemployment rates. The Scenario has not happened since Job Openings rose 7.74% to 9.61 Million, accelerating employment growth, and the U.S. economy created 336,000 new jobs, 48.02% more than last month.

Consumer Spending

Consumer spending represents a significant portion of economic activity. Retail, hospitality and consumer-focused entrepreneurs mainly depend on consumer sentiment and purchasing power. A prime rate above 10% can affect consumer spending; for every 1% increase in interest rates, consumer spending on interest-sensitive items such as housing and automobiles tends to decrease by about 2%. With a 5% to 10% prime rate hike, we could anticipate a 10% reduction in such spending.

As we have seen since March 2022, Higher mortgage rates can make housing less affordable, discouraging home purchases and slowing down the construction industry. The retail sector may experience a decline in demand for discretionary goods and services as consumers allocate more of their budgets essential items in their budgets.
Investment for growth can be affected.

A simulation based on historical investment data shows that a 3% increase in interest rates could lead to a 10% decline in capital investment. With a prime rate increase from 5% to 10%, we could anticipate a 33% decrease in capital investments by entrepreneurs.

Stock and Bond Markets Become Volatile

Nothing scares more quickly than a 100-dollar bill, and Financial markets are sensitive to changes in interest rates. A prime rate above 10% can significantly impact entrepreneurs as well as publicly traded companies.

Historical analysis suggests that a 1% rise in interest rates can lead to a 5% decline in stock prices and a 7% drop in bond prices. With the prime rate jumping from 5% to 10%, stock prices could decline by 25% and bond prices by 35%.

Increased market volatility can disrupt entrepreneurs' strategic planning and fundraising efforts. Such has been the case for IPOs and mergers and acquisitions deals on Wall Street that have been significantly reduced.

Credit Quality and Access to Capital

A prime rate above 10% can lead to changes in lending standards and credit quality as most lending institutions become more stringent in their lending criteria, placing a premium on borrower creditworthiness.

Entrepreneurs with lower credit quality may face higher borrowing costs or even credit denials, making it challenging to secure the necessary financing.

Small and medium-sized enterprises (SMEs) may be disproportionately affected, as they often rely on bank loans for capital. Stricter lending standards can hinder their growth prospects.

The Last Word: A Prime Rate of 10% is a Poison Pill

In conclusion, the impact of a prime rate rising above 10% on entrepreneurs and the broader economy is an economic poison pill.

Even though rates have increased 142.85% in the last 15 months, the labor markets remain solid, U.S. economic growth for the third quarter is at 4.90% GDP, and inflation has been reduced.

Entrepreneurs should stay informed about economic developments and central bank policies to make informed decisions in this challenging economic environment. We recommend conducting detailed financial analyses, stress tests, and scenario planning to assess how a rise in the prime rate would affect their businesses.

While navigating these challenges, entrepreneurs have a long history of adaptability and resilience, and many have successfully weathered economic storms by embracing innovation and prudent financial management.

As Author Gregory Williams said best, **"On the other side of a storm is the strength that comes from having navigated through it. Raise your sail & and begin".**

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