An unorthodox solution

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Challenging times call for unusual solutions, and the idea of negative interest rates is particularly unorthodox. Tim Rocks, Head of Market Research and Strategy, considers how negative interest rates operate and whether they can have a positive impact.

Charged for your savings?

Negative interest rates mean instead of earning interest on a deposit, you would be charged a fee for holding it in the bank. Sounds pretty terrifying when you apply that thought to your own savings account, doesn't it?

When used as a tool by central banks, such as the European Central Bank (ECB) or the Reserve Bank of Australia (RBA), it applies specifically to commercial banks. Commercial banks can use the central bank as a place to hold their money so the official interest rate set by the local central bank will indicate whether they earn, or pay, interest on the money they hold with the central bank.

While many central banks lowered official interest rates to extreme lows during and in the years since the global financial crisis, some have had to take a step further and go beyond zero. These have included some European countries led by Sweden and Switzerland and, more recently, Japan.

Turning a negative into a positive

While many investors have been concerned about negative interest rates, they have been used for very specific results. By charging commercial banks to hold money with them, central banks hope to encourage those banks to lend more money thus increasing business investing and consumer spending to boost the economy. They also hope to depreciate the local currency to encourage the exports market.

The question is whether this approach actually works given it hasn't been done until now.

The case in point: Sweden and negative interest rates

The Swedish central bank, the Riksbank, introduced negative interest rates along with asset repurchase programs in early 2015. There are early signs this has been supportive for them.

+ Based on recent data, Sweden is now one of the fastest growing advanced economies with more than double the GDP growth year-on-year compared to the broader Eurozone. (Source: Datastream)
+ Housing prices have risen by approximately 10% per annum in recent years creating a housing boom and increased household debt (representing increased confidence to borrow and increased access to loans. (Source: Datastream).
+ Inflation levels have increased and are now moving towards the Riksbank's target (Source: Riksbank)

Since Sweden was one of the earliest to move to negative interest rates, these results have also been encouraging for other countries.

Interest rates for my investments

As negative interest rates seek to encourage lending and consumer spending though, sharemarkets and property can benefit from these because it is cheaper to borrow money, and there is less return from holding funds in the bank in countries with those rates. Alongside Sweden, other European countries have seen some benefit in these areas from the negative official interest rate from the ECB.

On an Australian front, we still have one of the higher official interest rates on offer, despite the recent decrease from the RBA. There is plenty of room to move before the RBA would need to consider a negative interest rate and a number of policy actions in play to support the economy already. Australian fixed interest tends to offer better returns at the moment when compared to international fixed interest, though as a whole, the best opportunities for investments are likely to be areas that can benefit from low interest rates like sharemarkets or property.

For more information, please contact your financial planner.

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