3. Domestic Financial Conditions

Australian financial conditions have tightened further since the previous *Statement*. The Reserve Bank has increased the cash rate target by 25 basis points to 4.1 per cent and market pricing suggests that the cash rate may be increased once more by the end of the year. In response to these changes, money market rates and yields on Australian Government Securities (AGS) have increased alongside higher cash rate expectations and higher government bond yields globally.

Banks' funding costs have increased in response to increases in the cash rate and bank bill swap (BBSW) rates. Banks have increased both lending and deposit rates, although both have risen by less than the cash rate over the tightening phase. Scheduled mortgage repayments have increased further in recent months and will continue to rise as more fixed-rate loans roll off onto higher interest rates. At the same time, extra payments into offset and redraw accounts have declined as higher interest rates and cost-of-living increases put pressure on household budgets. Housing credit growth has stabilised, supported by a modest increase in housing loan commitments alongside a rise in housing prices; business credit growth has also levelled out of late.

The Australian dollar is little changed on a trade-weighted (TWI) basis since May. The yield differential between AGS and government securities of the major advanced economies has eased of late to be around its levels a few months ago. Meanwhile, concerns about the outlook for the Chinese economy have weighed on the Australian dollar and the prices of Australia's key commodity exports remain lower than earlier in the year.

The cash rate has increased

Market participants' expectations for the path of the cash rate, as implied by overnight index swaps (OIS), have increased since the previous *Statement* (Graph 3.1). At that time, it was expected that the prevailing cash rate of 3.85 per cent would be close to the peak in this tightening phase, in part reflecting lingering risks of banking stress in some countries overseas. Since then, the Reserve Bank has increased the cash rate target by 25 basis points to 4.1 per cent, and market pricing implies that the cash rate may be increased once more by the end of the year; this stands in contrast to market pricing in May, which had implied an expectation of reductions in the cash rate in the latter part of 2023. The median forecast of market economists is for a similar peak in the cash rate to that implied by market pricing.

Transaction volumes in the cash market have continued to increase, and the cash rate has been determined by market transactions almost every day since late March. The cash rate has remained 3 basis points below the cash rate target.

Money market rates have continued to rise

BBSW rates, which are a key influence on banks' funding costs, have risen by more than cash rate expectations over the past three months (Graph 3.2). This rise has been more pronounced

at the six-month tenor, driven – at least in part – by upcoming Term Funding Facility (TFF) maturities in August and September, with banks increasing issuance of longer dated bank bills to cover this period. The cost of sourcing Australian dollar funding offshore (by issuing short-term US dollar securities and swapping the proceeds in the foreign exchange market) also increased for a time in this period.

Repurchase agreement (repo) rates at the Bank's regular open market liquidity operations (OMO) have increased in line with OIS rates, with the OMO hurdle rate continuing to be set at term-matched OIS plus a modest spread. Demand for short-term Australian dollar liquidity obtained at OMO remains modest.

AGS yields have risen

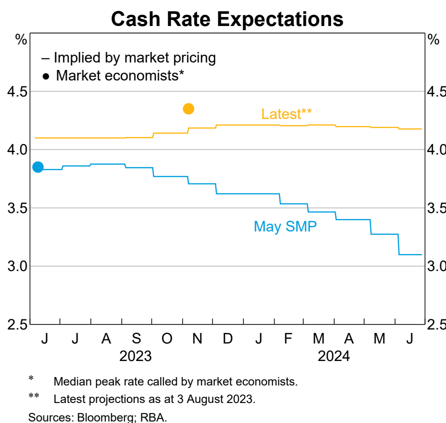
Over recent months, yields on AGS rose to their highest levels in around a decade (Graph 3.3). This was alongside an abatement of stresses in some overseas banking systems and increases in market participants' policy rate expectations amid persistent inflation. The rise in yields was most pronounced for short-term securities; in June, the yield on three-year AGS rose above that on 10-year AGS for the first time since 2008. More recently, AGS yields have fallen from their peaks alongside lower inflation outcomes in Australia and some other countries and as expectations for further policy tightening have lessened.

The increase in AGS yields has been underpinned by a rise in real yields, while break-even inflation rates have remained relatively stable and well anchored (Graph 3.4). This implies that market participants expect the Reserve Bank to keep inflation within the target range over the medium term.

Yields on 10-year AGS are around those on US Treasuries, while three-year AGS yields remain below US Treasury yields (Graph 3.5).

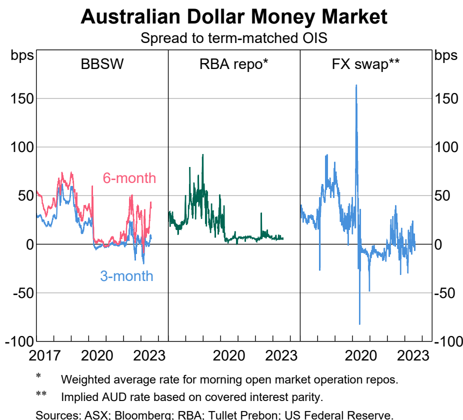
Yields on semi-government securities (semis) have increased by less than AGS yields, with the

Graph 3.1



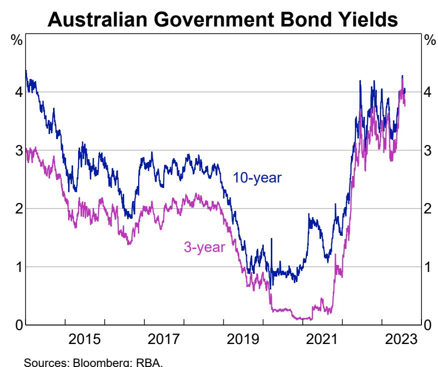
* Median peak rate called by market economists.
** Latest projections as at 3 August 2023.
Sources: Bloomberg; RBA.

Graph 3.2



* Weighted average rate for morning open market operation repos.
** Implied AUD rate based on covered interest parity.
Sources: ASX; Bloomberg; RBA; Tullet Prebon; US Federal Reserve.

Graph 3.3



Sources: Bloomberg; RBA.

spread to AGS yields around their narrowest levels in about a year (Graph 3.6). Strong issuance of semis has been met with strong demand – including from domestic banks to hold semis as part of their portfolios of high-quality liquid assets (HQLA).

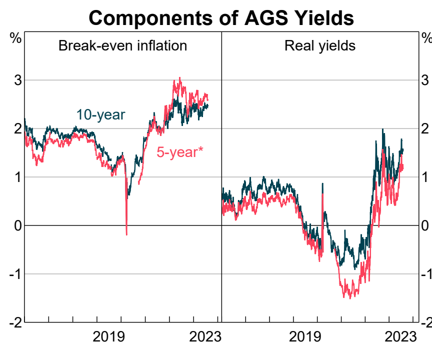
Bond markets are functioning well

Bid-offer spreads on AGS and semis are very low, and demand from both domestic and international investors remains strong. The volatility of yields has declined in recent months to be around its historical average as concerns around offshore banking stresses have abated (Graph 3.7). Demand to borrow AGS from the Bank has continued to decline in recent months, with an average of around $2 billion of bonds borrowed per day since the previous *Statement*.

Issuance of AGS over the year to date by the Australian Office of Financial Management (AOFM) has been well below that of recent years (Graph 3.8). In June, the AOFM stated that issuance in the 2023/24 fiscal year will be lower than the $75 billion plan announced in the Budget, reflecting a larger government surplus in the 2022/23 fiscal year than had been forecast. Semis issuance has remained strong in 2023, with issuance to date higher than observed in recent years.

Graph 3.4

Components of AGS Yields

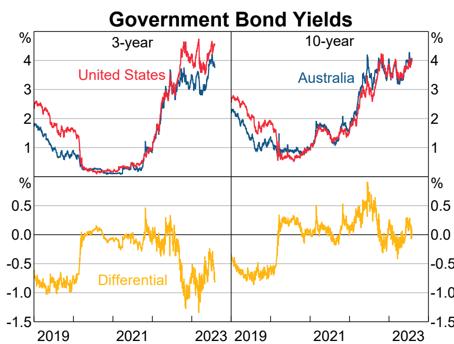


* 5-year breakeven inflation unavailable from April 2020 to September 2020 due to data quality issues.

Sources: Bloomberg; RBA.

Graph 3.5

Government Bond Yields

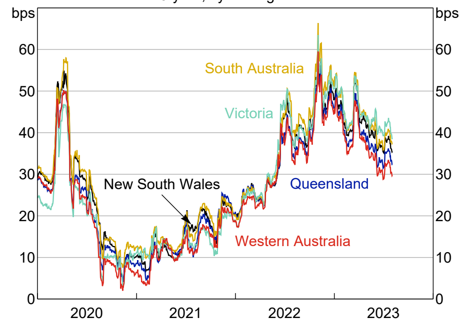


Sources: Bloomberg; RBA.

Graph 3.6

Semi-government Bond Spreads to AGS

5-year; by issuing state

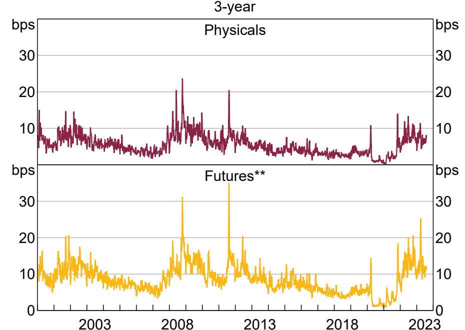


Sources: Bloomberg; RBA.

Graph 3.7

Bonds Intraday Range*

3-year



* Ten-day moving average.

** Includes overnight session.

Sources: Bloomberg; RBA.

The Bank's balance sheet has decreased and is set to decline further

The Bank's balance sheet has decreased by $25 billion to around $590 billion since the previous *Statement*. The decrease was driven by TFF loan maturities and a reduction in the market value of the Bank's bond holdings, owing to a rise in bond yields over the past few months (Graph 3.9). This fall in assets was matched on the liabilities side by a fall in commercial banks' Exchange Settlement (ES) balances, as maturing TFF loans were repaid (Graph 3.10). The Bank's balance sheet will decline noticeably over the next few years as bond purchases and TFF funding provided to banks mature.

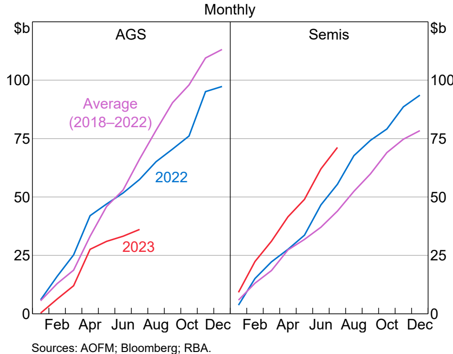
The Term Funding Facility has begun to unwind

A total of $188 billion of funding was provided under the TFF, of which $25 billion had matured by the end of July, with a further $53 billion to mature in August and September. This represents the first of two concentrated maturity periods, with $93 billion to mature in the June 2024 quarter (Graph 3.11).

Banks use their ES balances to repay the TFF. These ES balances qualify as HQLA for the purpose of banks' regulatory liquidity ratios. However, most of the collateral that have secured banks' TFF loans are self-securitised

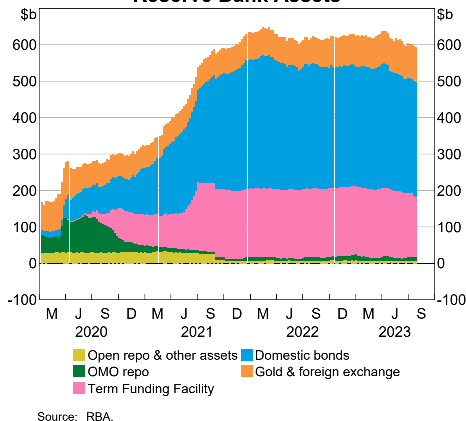
Graph 3.8

Cumulative Gross Issuance



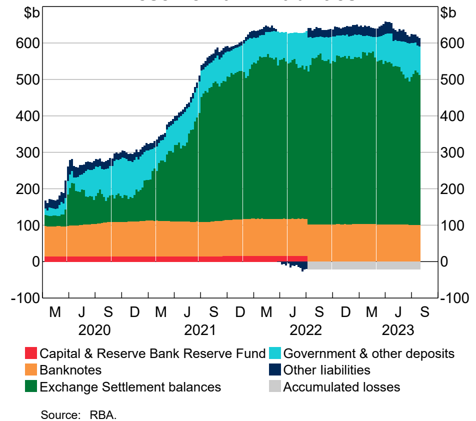
Graph 3.9

Reserve Bank Assets



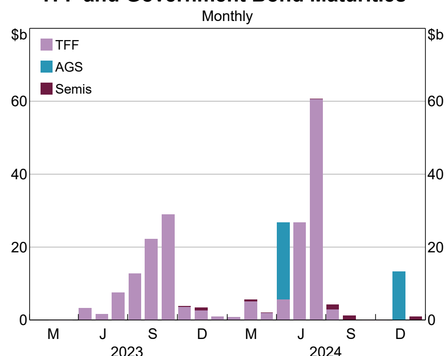
Graph 3.10

Reserve Bank Liabilities



Graph 3.11

TFF and Government Bond Maturities*



assets, which do not qualify as HQLA. Banks can source replacement HQLA if they choose to offset the impact of TFF maturities on their liquidity ratios, which are currently well above regulatory requirements. Indeed, bank bond issuance has been above average over 2023 to date, with some of this funding being used to purchase HQLA securities. Even so, TFF loan maturities are not expected to increase bank funding costs materially. This is because TFF loans accounted for only around 5 per cent of banks' funding when it was provided and banks have hedged much of this borrowing (and hence funding costs) back to floating rates, which have already increased alongside the cash rate.

Bank bond issuance is above average in gross and net terms

Bank bond issuance has slowed over recent months but remains above average over 2023 to date following strong issuance earlier in the year (Graph 3.12). Banks raised $32 billion via bond issuance over the past three months, evenly split between domestic and offshore markets. Covered bond issuance was particularly strong, increasing to $11 billion, with over two-thirds of this offshore; this strength may, in part, reflect increased investor preference for secured products given uncertainty about the economic outlook.

Yields on three-year banks bonds have increased over recent months alongside higher swap rates and AGS yields, to be over 5 per cent (Graph 3.13). The spread to the swap rate for bonds issued by the major banks has declined slightly but remains around the range seen in the years prior to the pandemic. Banks generally swap fixed-rate payments on newly issued bonds into floating-rate payments to match their floating-rate loan assets, and so the spread to swap is an important component of bank funding costs.

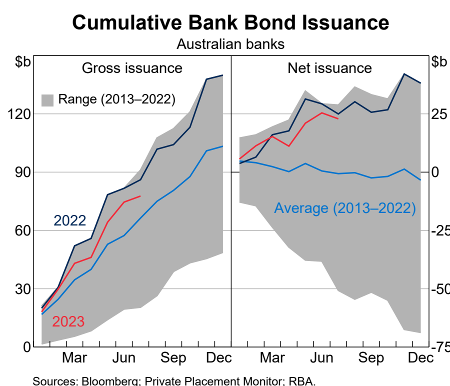
Issuance of asset-backed securities has been high over recent months

Issuance of asset-backed securities (ABS) was around $12 billion over the past three months (Graph 3.14). Residential mortgage-backed securities (RMBS) accounted for over two-thirds of this. Issuance continued to be driven primarily by non-bank lenders, which use the securitisation market as their key source of funding. Issuance of other ABS increased to $3 billion, driven by issuance of securities backed by auto and equipment assets. Strong issuance of 'other ABS' over the year to date partly reflects non-bank lenders shifting their lending from housing mortgages, where they have become less competitive compared with banks, towards other types of loans. RMBS

Graph 3.12

Cumulative Bank Bond Issuance

Australian banks

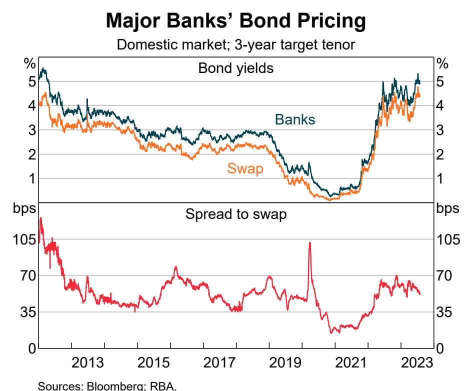


Sources: Bloomberg; Private Placement Monitor; RBA.

Graph 3.13

Major Banks' Bond Pricing

Domestic market; 3-year target tenor

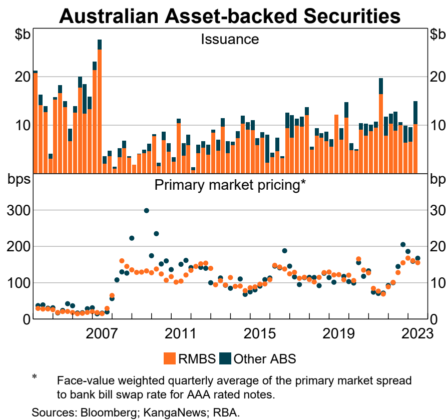


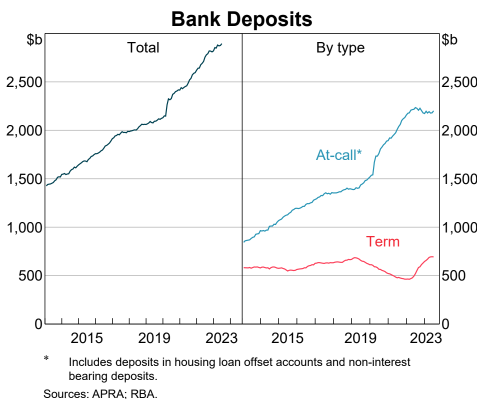
Sources: Bloomberg; RBA.

spreads have declined slightly in recent months, while spreads on other ABS remain at the wider end of their pre-pandemic range.

Deposit growth has slowed

The total stock of deposits has grown more slowly over the past six months than during the pandemic, in part because slowing credit growth creates fewer new deposits (Graph 3.15). Depositors have continued to shift from at-call deposits to term deposits, which typically offer significantly higher returns (see below).





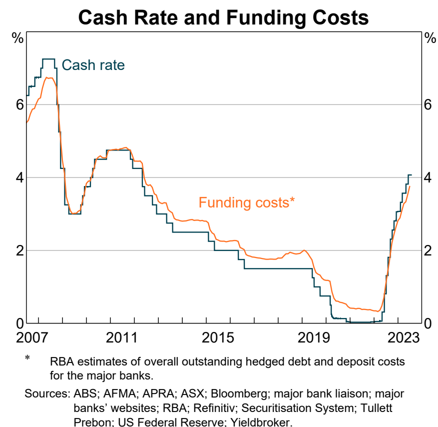
Bank funding costs have increased further

Banks' overall funding costs rose in the June quarter, underpinned by higher BBSW rates (Graph 3.16). Much of banks' wholesale debt and deposit costs are linked to BBSW rates either directly or through banks' hedging activities. This includes banks swapping foreign-currency denominated and fixed-rate liabilities for floating-rate exposures that reference BBSW.

Deposit rates have risen more on some products than others

The average rate on outstanding at-call deposits – comprising around three-quarters of total deposits – has risen by 240 basis points since May 2022, which is 160 basis points less than the increase in the cash rate (Graph 3.17). This includes around 10 per cent of at-call balances on which banks pay no interest (although banks often hedge such deposits to mitigate volatility in earnings so their effective cost to banks increases with BBSW rates). Banks have increased advertised rates on 'bonus savers' (where depositors must meet certain conditions to receive a higher interest rate) more than on standard at-call savings accounts.

The average rates on new term deposits have increased by more than the cash rate since the



start of the cash rate tightening phase, in line with larger movements in BBSW and swap rates, which are the key benchmarks used to price these products. Rising term deposit rates also partly reflect banks' interest in growing term deposits given their favourable treatment in liquidity ratios (compared with at-call deposits) as they prepare for TFF maturities.

In February, the Treasurer directed the Australian Competition and Consumer Commission to conduct an inquiry into the market for retail deposits, including on the interest rates paid on deposits and the nature and extent of competition in the supply of this product.[1] The final report is due in December this year.

Lending rates have increased by less than the cash rate

The average rate charged on all outstanding housing and business loans has increased by around 300 basis points since May 2022, 100 basis points less than the cash rate (Graph 3.18). Housing loans (around two-thirds of total credit) account for most of this difference. Lending rates have increased a little more than deposit rates on average.

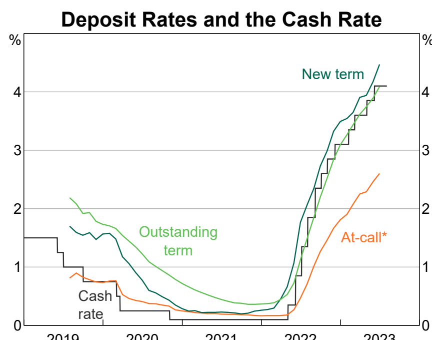
The average outstanding mortgage rate has increased by around 275 basis points since May 2022, 125 basis points less than the cash rate (Graph 3.19). This divergence reflects the high share of fixed-rate housing loans outstanding and, to a lesser extent, the effect of discounting on variable-rate housing loans associated with strong competition between lenders. The share of borrowers rolling off fixed-rate mortgages – taken out two to three years ago at low interest rates – onto much higher rates peaked at just under 5½ per cent of outstanding housing credit in the June quarter; it will stay high for the rest of this year, before declining in 2024 (Graph 3.20). These expiries will see the average outstanding mortgage rate continue to increase as the effect of the rise in the cash rate since May 2022 flows through to a greater share of borrowers.

Competition for housing loans has eased in recent months

Strong competition in the mortgage market has seen the average rate on outstanding variable-rate loans increase by around 65 basis points less than the cumulative increase in the cash rate up to June (Table 3.1). In more recent months, however, there have been signs that competition has eased. In particular, the average variable rate on new housing loans increased by 29 basis points in June; this was more than the

Graph 3.17

Deposit Rates and the Cash Rate



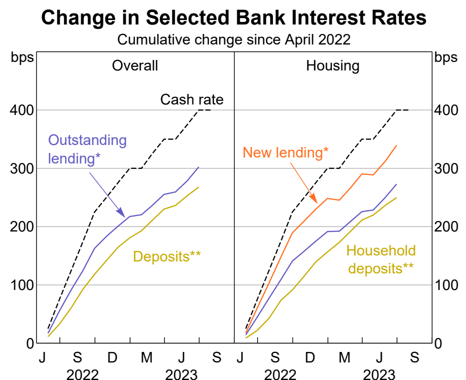
* Excludes deposits in housing loan offset accounts; includes non-interest bearing deposits.

Sources: APRA; RBA.

Graph 3.18

Change in Selected Bank Interest Rates

Cumulative change since April 2022



* Includes non-banks.

** Excludes deposits in housing loan offset accounts, includes non-interest bearing deposits.

Sources: APRA; RBA.

Table 3.1: Average Outstanding Housing Rates

June 2023

	Interest rate June 2023 Per cent	Change since Apr 2022 Basis points	Change since Feb 2020 Basis points
Cash rate	4.10	400	335
Variable-rate loans			
– Owner-occupier	6.24	338	267
– Investor	6.57	336	260
– All variable-rate loans	6.35	337	264
Fixed-rate loans			
– Owner-occupier	2.89	66	–84
– Investor	3.19	60	–82
– All fixed-rate loans	2.99	63	–87
Loans by repayment type[(a)]			
– Principal-and-interest	5.40	272	178
– Interest-only	6.04	280	181

(a) Weighted average across variable- and fixed-rate loans.

Sources: APRA; RBA.

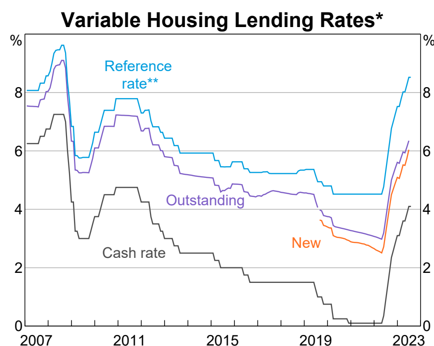
increase in the cash rate, a first for this tightening phase. Also, lenders have reduced discounts on their advertised lending rates and most have now withdrawn cashback offers for new or refinancing borrowers. The share of newly funded housing loans taken out at a fixed interest rate increased a little in the June quarter but remains well below pre-pandemic levels, at around 8 per cent.

Scheduled housing loan payments have increased further

Scheduled mortgage payments – interest plus scheduled principal – increased to 9.4 per cent

Graph 3.19

Variable Housing Lending Rates*



* Reference rates to end July 2023; new and outstanding rates to end June 2023. Series break for new and outstanding loans in July 2019.

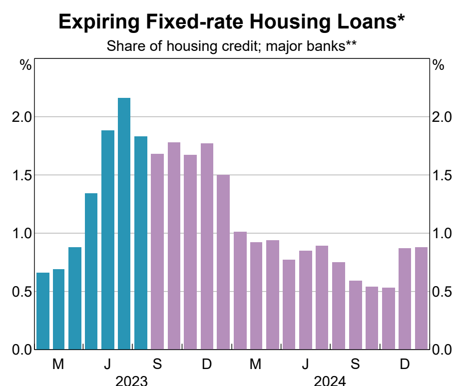
** Major banks' standard reference rates for variable-rate owner-occupier loans.

Sources: APRA; banks' websites; CANSTAR; Perpetual; RBA; Securitisation System.

Graph 3.20

Expiring Fixed-rate Housing Loans*

Share of housing credit; major banks**



* Loans expiring beyond 2024 not available monthly. Blue-coloured bars represent months that have already occurred.

** Value of major banks' housing credit outstanding as at June 2023.

Sources: APRA; major banks; RBA.

of household disposable income in the June quarter (Graph 3.21). Scheduled payments have risen by around 2¼ percentage points of household disposable income since the March quarter of 2022 and will continue to increase as borrowers with expiring fixed-rate loans roll off onto higher rates. Based on cash rate increases to date, scheduled payments are projected to increase to an historical high of around 9.8 per cent of household disposable income by the end of the year and around 10.1 per cent by the end of 2024.

Extra payments into borrowers' offset and redraw accounts declined in the June quarter. Net flows into these accounts have decreased significantly from the highs seen during the pandemic to be noticeably below pre-pandemic averages, which is consistent with pressures on disposable incomes from increases in interest rates and the broader rise in the cost of living (Graph 3.22). While borrowers in aggregate have continued to add to the stock of savings held in these accounts – partly supported by fixed-rate borrowers transferring savings from other sources when their fixed-rate periods expire – some borrowers have been drawing on their stocks of savings to help meet mortgage payments and support consumption in the face of declines in their real disposable incomes.

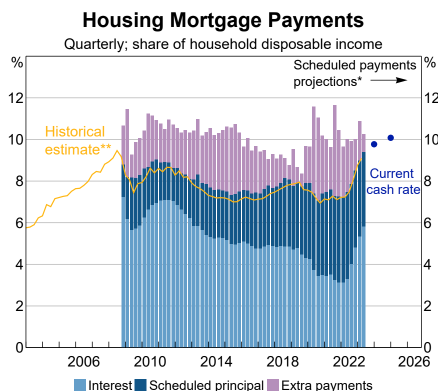
Growth in total credit has stabilised in recent months

Total credit growth has stabilised in recent months, having fallen from its peak in late 2022 (Graph 3.23). Housing credit growth has levelled out, supported by an increase in housing loan commitments alongside a rise in housing prices (see Chapter 2: Domestic Economic Conditions). Business credit growth has also stabilised. Personal credit growth is little changed and personal credit outstanding remains well below levels prior to the pandemic. Outstanding credit has declined as a share of nominal GDP since 2017 (Graph 3.24).

Demand for new housing loans has increased, and refinancing remains high

New housing loan commitments have increased by around 8 per cent since the recent low in February, alongside an uptick in housing prices (Graph 3.25). The recent pick-up in new housing loans has been broadly based across owner-occupiers and investors and across all states and territories. Nonetheless, commitments remain 28 per cent below the January 2022 peak.

Graph 3.21

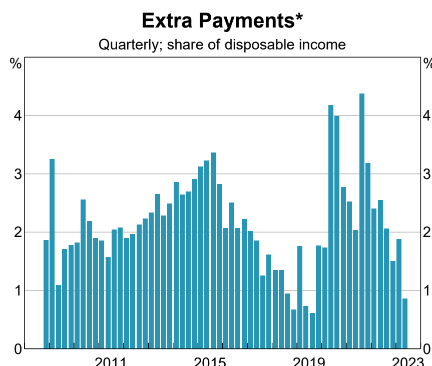


* Projections incorporate fixed-rate roll off to variable rates and the observed gap between cash rate increases and increases to variable loan rates. The current cash rate is 4.1 per cent.

** Estimated scheduled payments using credit foncier model.

Sources: ABS; APRA; RBA.

Graph 3.22



* Payments into offset and redraw accounts; data are break-adjusted and seasonally adjusted.

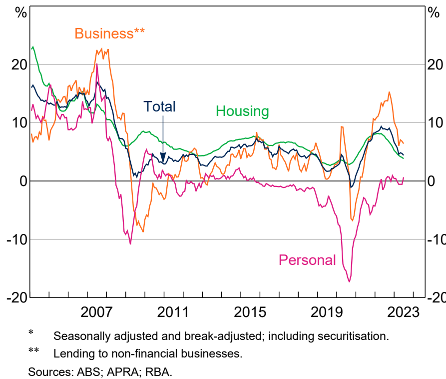
Sources: ABS; APRA; RBA.

Consistent with the recent pick-up in new housing loans, housing credit growth has shown signs of stabilising in recent months. However, non-bank housing credit growth has fallen sharply since late 2022, reflecting both weakness in new lending and borrowers refinancing away from non-bank lenders towards banks (Graph 3.26). Compared with banks, non-bank lenders have been less able to compete for housing loans due to larger increases in funding costs as seen in wider RMBS spreads over much of the tightening phase (discussed above).

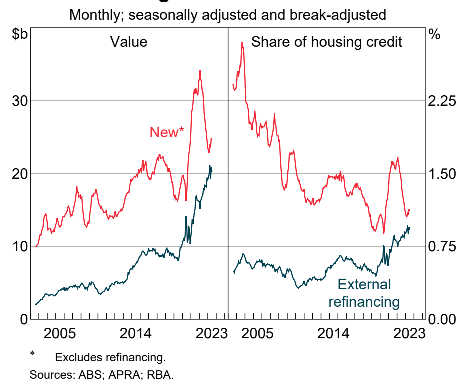
Commitments for external refinancing (switching to a new lender) remain at very high levels. A large share of variable-rate borrowers have sought a better deal on their mortgage as interest rates and the cost of living have increased. External refinancing activity is also being supported by the large number of borrowers rolling off fixed-rate loans, some of whom are switching lenders to obtain a more favourable rate.

Some borrowers may face difficulties refinancing

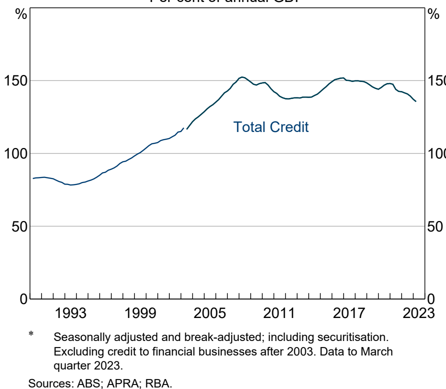
At its June meeting, the Council of Financial Regulators (CFR) recognised that some borrowers were facing challenges in refinancing because of a range of difficulties, including in meeting serviceability requirements. The



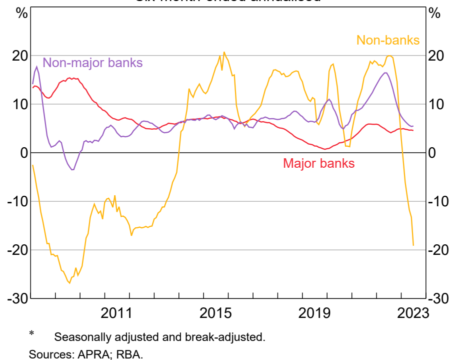
* Seasonally adjusted and break-adjusted; including securitisation.
** Lending to non-financial businesses.
Sources: ABS; APRA; RBA.



* Excludes refinancing.
Sources: ABS; APRA; RBA.



* Seasonally adjusted and break-adjusted; including securitisation. Excluding credit to financial businesses after 2003. Data to March quarter 2023.
Sources: ABS; APRA; RBA.



* Seasonally adjusted and break-adjusted.
Sources: APRA; RBA.

Australian Prudential Regulation Authority (APRA) requires banks to apply a buffer of 3 percentage points above the current loan rate in assessing a new or a refinancing borrower's ability to service mortgage payments. In some cases, this may mean that a borrower cannot refinance to a similar product, even if doing so could reduce their payments.

The CFR supported APRA's assessment that the serviceability buffer is at the appropriate level given the current environment, including the high degree of uncertainty and risks to the economic outlook. The CFR also noted that APRA's prudential framework allows for some limited exceptions to the serviceability policy. In line with this framework, some banks have recently made changes to their exceptions processes to allow refinancing for borrowers who do not meet APRA's serviceability buffer but do meet other criteria (such as a good repayment history and no increase in the loan amount). APRA has written to banks to outline its expectations for the management of exceptions, which include setting prudent limits and monitoring this lending closely. Around 3 per cent of new loans since late 2021 were written under exceptions to banks' serviceability policies.

Interest rates on business loans have risen and growth in business debt has stabilised

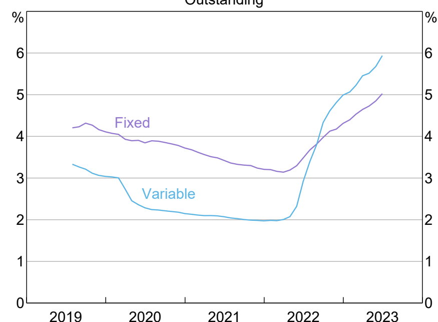
Interest rates on business loans have risen in recent months, reflecting increases in the cash rate and BBSW rates (Graph 3.27). BBSW rates are the standard benchmark rates used to price loans to medium and large businesses.

Growth in business debt, and commitments for new business lending, have stabilised in recent months but remain well below their peaks in late 2022 (Graph 3.28). Growth in lending to the property services industry has slowed, consistent with weaker conditions in commercial property markets; however, this has been partly offset by increased growth in lending to goods-related industries, particularly agricultural businesses.

Australian equity prices have increased

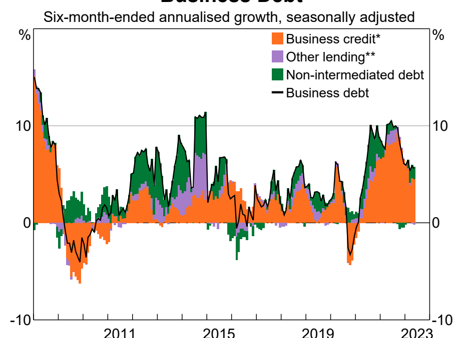
The ASX 200 index has increased by 3 per cent since May on a total return basis and is around its previous peak in February (Graph 3.29). Australian equity prices have underperformed the United States and other international equity markets since May. This partly reflects the composition of the Australian market, which has a smaller IT sector and a larger resources sector compared with many other markets.

Graph 3.27



Sources: APRA; RBA.

Graph 3.28

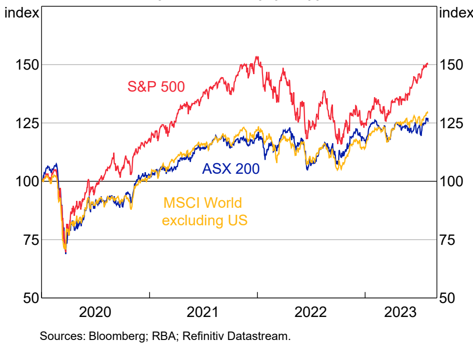


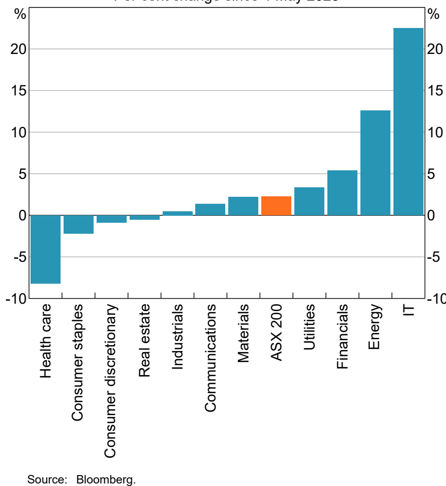
* Excludes lending to financial businesses.

** Lending to large businesses by institutions that do not report to APRA.

Sources: APRA; Bloomberg; RBA; Refinitiv.

Information technology stocks have increased notably over recent months, reflecting increased investor interest in stocks thought to be likely to benefit from artificial intelligence (Graph 3.30). Energy stocks have also risen alongside a rise in oil prices. Financials stocks have rebounded from lows reached during the overseas banking stress earlier in the year, supported by stronger-than-expected earnings results in the United States of late. By contrast, health care share prices declined alongside profit forecast downgrades.



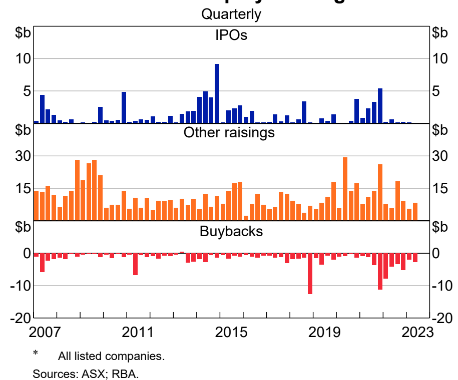


Equity raisings remain subdued

Equity raisings remained subdued in the first half of the year following low activity in 2022, including the lowest annual value raised from initial public offerings (IPOs) in the past two decades. Overall, around $140 million was raised through IPOs in the first half of 2023, largely in the resources sector; this follows relatively strong IPO activity in 2021 (Graph 3.31).

The Australian dollar has depreciated of late

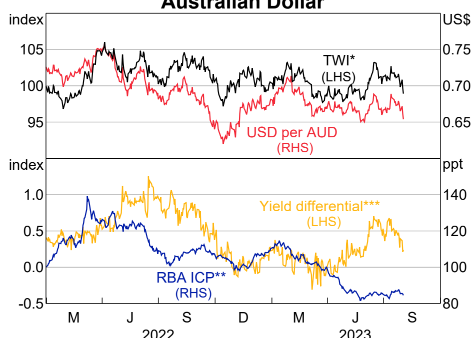
On a TWI basis, the Australian dollar is around its level at the May *Statement*, while it is lower against the US dollar at below US$0.66 (Graph 3.32). The exchange rate had appreciated alongside an increase in the yield differential between AGS and those of its major trading partners following increases in Australia's policy rate in May and June. However, more recently, the exchange rate has depreciated following weaker-than-expected domestic data, including for inflation, and after the cash rate was left unchanged in August. At the same time, concerns about the strength of China's economic recovery have weighed on the Australian dollar versus other currencies, and the RBA Index of Commodity Prices remains well below its levels from earlier in the year.



The Australian dollar TWI has been supported by an appreciation against the Japanese yen and Chinese renminbi over recent months, which together account for around 40 per cent of the TWI basket (Graph 3.33). In Japan, yields have remained low as the Bank of Japan has maintained highly accommodative policy settings. In China, bond yields have fallen alongside concerns about the outlook for the Chinese economy and as Chinese authorities have eased monetary policy (see Chapter 1: The International Environment).

Graph 3.32

Australian Dollar



* Trade-weighted index; 31 December 2021 = 100.

** Index of Commodity Prices (USD terms); 31 December 2021 = 100.

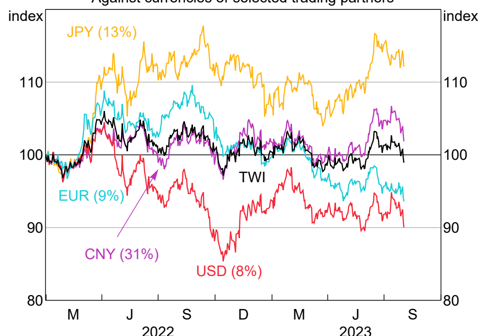
*** Three-year Australian sovereign yield less yields of the United States, Japan and Germany, weighted by GDP.

Sources: Bloomberg; RBA; Yieldbroker.

Graph 3.33

Australian Dollar*

Against currencies of selected trading partners



* Indexed to 31 December 2021 = 100; TWI weights in parentheses.

Sources: Bloomberg; RBA.

Australia's financial account deficit narrowed in the March quarter

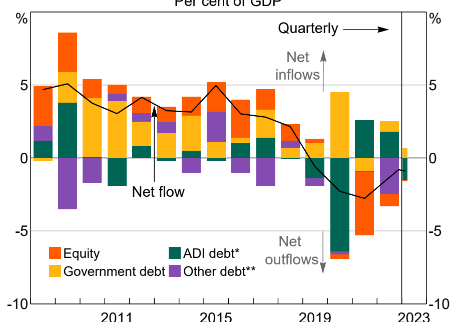
The narrowing of Australia's financial account deficit in the March quarter of 2023 was caused by a smaller net outflow of capital compared with the December 2022 quarter (Graph 3.34). Net capital outflows were partly driven by a withdrawal of deposits from foreign banks to support intragroup funding and liquidity management activities during the quarter, alongside the collapse of several US banks and Credit Suisse.

Australia's net foreign liability position as a percentage of GDP decreased over the March quarter to its lowest level since the 1980s (Graph 3.35). The recent decline was driven by a small widening in Australia's net foreign equity asset position, partly reflecting valuation effects associated with an increase in foreign equity prices and the depreciation of the Australian Dollar. The net income deficit, which comprises net payments made on Australia's net foreign liability position, widened slightly to around 4½ per cent of GDP in the March quarter, and remains at historically high levels. The increase in the net income deficit reflected a decline in primary income credits driven by lower profits on Australian-owned overseas assets across most sectors. ✠

Graph 3.34

Net Capital Flows

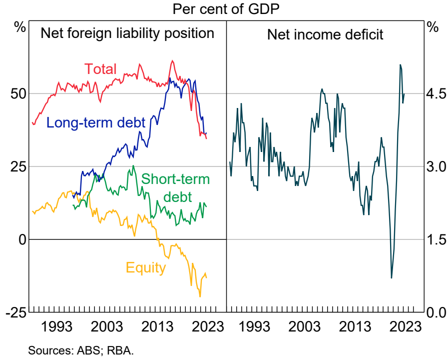
Per cent of GDP



* Includes derivative settlement, adjusted for the US dollar swap facility in 2008–2009 and 2020.

** Includes public corporations and private sector.

Sources: ABS; RBA.



Endnote

[1] See Australian Competition and Consumer Commission (2023), 'Retail Deposits Inquiry 2023'.