2. International Financial Conditions

Global financial conditions continue to support economic growth. Monetary policy settings remain very accommodative and some central banks are expected to provide additional stimulus in the months ahead. Sovereign bond yields remain low and stable, reflecting the subdued economic and inflation outlook and the effects of central bank purchases. Corporate bond yields are very low and equity prices remain substantially higher than their March lows. Corporate earnings improved in the September quarter, but remain significantly lower than a year ago. The exchange rates of major advanced economies have been little changed since the previous *Statement*. The Australian dollar has depreciated from its recent peak in late August; much of this reflects the increase in market expectations, and then the introduction of further policy easing by the Reserve Bank at its November meeting. Financial conditions have been stable in recent months in most emerging markets, while in China, bond yields have risen further alongside the economic recovery and the Chinese renminbi has appreciated.

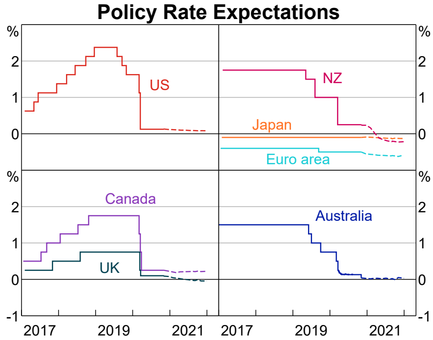
The policy settings of central banks in advanced economies will remain accommodative for a prolonged period

Central banks in advanced economies continue to provide monetary stimulus to support the economic recovery. Market analysts also expect some central banks to provide additional monetary stimulus in the coming months in response to shortfalls in demand and low inflation. An increase in COVID-19 cases in Europe and the United States is also expected to weigh on economic activity in the near term.

Central banks have given strong guidance that policy rates will remain at current or lower levels for several years, because inflation is expected to remain below target and unemployment rates elevated for an extended period (Graph 2.1). Some central banks continue to indicate that lower or negative policy rates are under consideration. The Reserve Bank of New Zealand (RBNZ) noted that banks' systems and processes are expected to be ready for negative interest rates by the end of the year. Also, the Bank of England (BoE) has begun consulting financial institutions on their operational readiness to deal with a zero or negative policy rate, should it be warranted by the economic outlook at some stage. Meanwhile, other central banks – including the Federal Reserve (Fed) and the Bank of Canada (BoC) – have indicated that their policy rates have reached the effective lower bound and are expected to remain above zero.

Graph 2.1

Policy Rate Expectations



Sources: Bloomberg; RBA

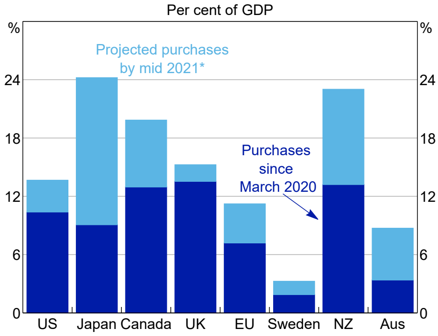
Central banks continue to provide substantial stimulus via asset purchase programs, and are expected to do so for some time yet (Graph 2.2). Purchases of government bonds or other assets by some central banks, such as the Fed, have slowed as market conditions have improved. The BoC also announced that it would reduce the volume of weekly purchases, while simultaneously shifting its purchases towards longer-maturity bonds to maintain the level of stimulus provided by the program. At the same time, other central banks, including the Reserve Bank of Australia, RBNZ and the Swedish Riksbank, have recently expanded their purchase programs to support economic activity. A few central banks, including the European Central Bank (ECB) and the BoE, are expected to extend or expand their programs in the coming months. The ECB has indicated that it will 'recalibrate' its instruments in December to support the economic recovery and counteract the negative impact of the pandemic and the reintroduction of restrictions on the projected inflation path.

A number of central banks continue to support the flow of funding to businesses through lending facilities that provide long-term, low-cost funding for banks, often with incentives to increase lending to the private sector (Graph 2.3). In the euro area, banks borrowed a further €175 billion in the latest round of the ECB's targeted longer-term refinancing operations (TLTRO III), taking the total outstanding amount of loans under the TLTROs to around €1.7 trillion (17 per cent of GDP). Take-up of the Bank of Japan's lending facilities has also increased steadily in recent months, with loans outstanding reaching around ¥48 trillion (9 per cent of GDP) at the end of October. In the United Kingdom, the BoE's Term Funding Scheme With Additional Incentives for Small and Medium-sized Enterprises (TFSME) has made around £49 billion in loans (3 per cent of GDP). The BoE noted that lending under the TFSME was expected to exceed £100 billion over the coming year based on provisional plans submitted by participating firms. Elsewhere, the RBNZ highlighted its intention to deploy a Funding for Lending Programme before the end of the year to provide additional stimulus ahead of a possible policy rate reduction in 2021. Finally, the Fed eased the terms of its Main Street Lending Program, which purchases loans made by banks to small and medium-sized enterprises. The Fed lowered the minimum size of eligible loans from US$250 000 to US$100 000, and adjusted the fees associated with the program to encourage the provision of smaller loans.

In the United States, the Fed revised its monetary policy framework after completing a comprehensive review. The key changes to the

Graph 2.2

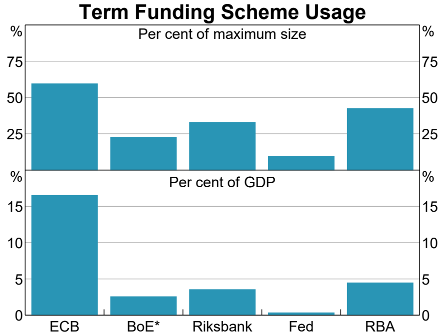
Central Bank Purchases of Government Debt



* Projections are based on purchase targets and recent rate of purchases
Sources: Central banks; RBA; Refinitiv

Graph 2.3

Term Funding Scheme Usage



* Maximum size refers to initial allowance only
Sources: Central banks; Refinitiv

statement on its longer-run goals and strategy were:

- **The introduction of an 'average inflation target'.** To anchor inflation expectations around 2 per cent the Fed will seek to achieve inflation that averages 2 per cent over time. To achieve this, the Fed will allow inflation to increase moderately above 2 per cent for some time following periods of persistently below-target inflation.
- **Re-characterisation of the maximum employment goal.** The Fed's policy decisions will be based on assessments of the 'shortfall' of employment from its maximum level, rather than 'deviations'. This implies an asymmetric approach, whereby an unemployment rate below the estimated longer-run rate alone would not be a sufficient reason to tighten policy. The Fed also emphasised the importance of the employment objective by moving it ahead of the inflation goal in the statement, and by describing the maximum level of employment as a 'broad-based and inclusive goal'.
- **Placing more emphasis on financial stability.** The revised statement notes that 'sustainably achieving maximum employment and price stability depends on a stable financial system'.

The Fed updated its forward guidance following the release of the new statement, indicating that the policy rate will not be increased until the labour market has reached maximum employment and inflation has risen to 2 per cent and is on track to moderately exceed 2 per cent for some time.

The ECB is conducting a review of its monetary policy strategy that will consider the definition of its price stability objective, including the level of the inflation target and the usefulness of strategies to respond to long periods of low inflation, the effect of structural forces on the relationship between inflation and the real economy, and the monetary policy toolkit. The ECB will also consider how issues such as social inclusion, climate change and financial stability are relevant to their mandate.

Government bond yields remain historically low

Government bond yields in advanced economies remain very low despite substantial issuance by fiscal authorities (Graph 2.4). This is consistent with expectations that economic activity and inflationary pressures will remain subdued for an extended period, and guidance from central banks that policy rates will stay low for several years and that asset purchase programs will continue.

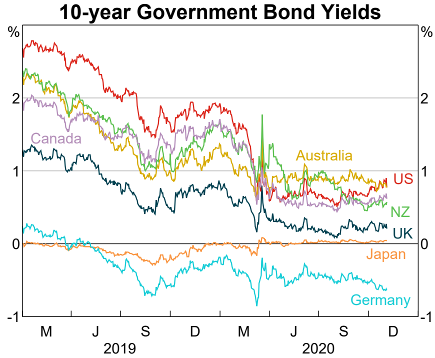
Since March, most major central banks have purchased the equivalent of more than half of net government debt issuance, while purchases by the BoE have been the equivalent of around 95 per cent of issuance (Graph 2.5). In contrast, government debt purchases by the RBA and the Riksbank in the secondary market have been closer to 25 per cent of issuance (Graph 2.6).

Funding conditions remain favourable for most corporate borrowers

Corporate funding conditions have eased significantly since March. Bond yields are at historically low levels and credit spreads are

Graph 2.4

10-year Government Bond Yields



Sources: Bloomberg; Yieldbroker

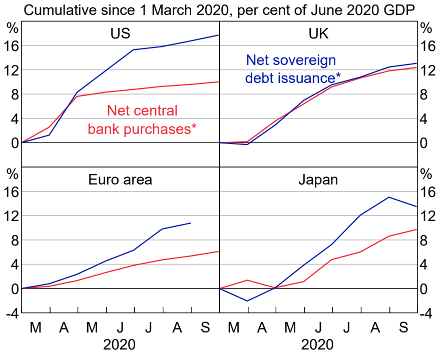
around their long-run averages (Graph 2.7). Investor confidence has been supported by the significant easing in fiscal and monetary policies, including measures specifically aimed at supporting credit markets. This, in turn, has facilitated an increase in borrowing by firms in response to the pandemic: the pace of bond issuance and growth in business credit has been robust this year, although it has eased recently because firms already have substantial amounts of funding (Graph 2.8). At the same time, bank lending standards have tightened in many jurisdictions. To support the supply of credit through the banking system, fiscal and monetary authorities implemented loan guarantee programs and funding for lending schemes, while also encouraging banks to draw on their capital buffers to extend credit to households and businesses.

Although financial conditions have eased, the impact of the pandemic on economic activity has seen a rise in the number of companies that have defaulted on their debt. In the United States and Europe, defaults in the June quarter increased to levels last seen during the global financial crisis, before easing slightly in the September quarter (Graph 2.9). So far, defaulting firms have been largely concentrated in sectors most affected by the pandemic, including the retail, leisure, entertainment and energy sectors. The number of corporate defaults is expected to

Graph 2.5

Sovereign Debt Issuance and Central Bank Purchases

Cumulative since 1 March 2020, per cent of June 2020 GDP



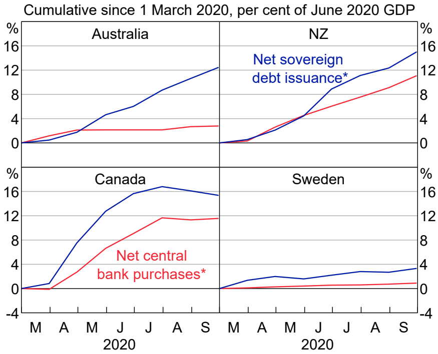
* Net of maturities

Sources: BoE; BoJ; ECB; Fed; Refinitiv; UK Debt Management Office

Graph 2.6

Sovereign Debt Issuance and Central Bank Purchases

Cumulative since 1 March 2020, per cent of June 2020 GDP

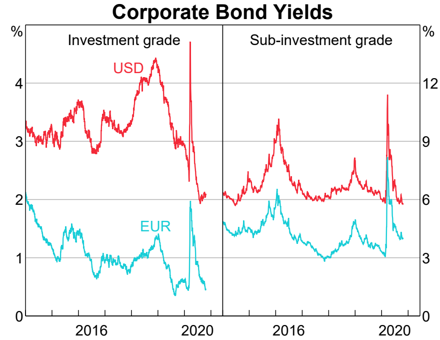


* Net of maturities

Sources: BoC; RBA; RBNZ; Refinitiv; Riksbank

Graph 2.7

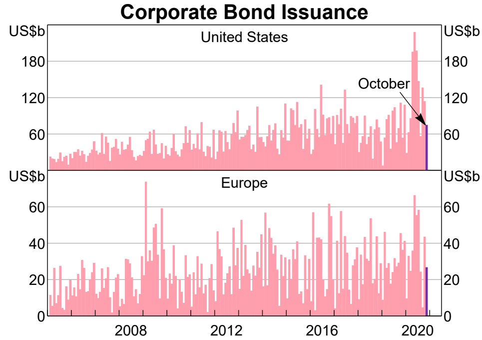
Corporate Bond Yields



Source: ICE Data is used with permission

Graph 2.8

Corporate Bond Issuance



Source: Dealogic

Table 2.1: Changes in International Share Prices
Per cent

	Since previous *Statement*	Since recent trough	Since pre-COVID-19 peak
United States	3	54	2
Euro area	0	35	–16
United Kingdom	–2	18	–22
Japan	6	43	–1
Australia	0	33	–15
China	1	36	14
World	**0**	**43**	**–4**

Source: Bloomberg

remain elevated over the remainder of the year, consistent with reduced levels of economic activity. Credit spreads have nonetheless declined to around their longer-run averages, because investors expect that public sector support will continue.

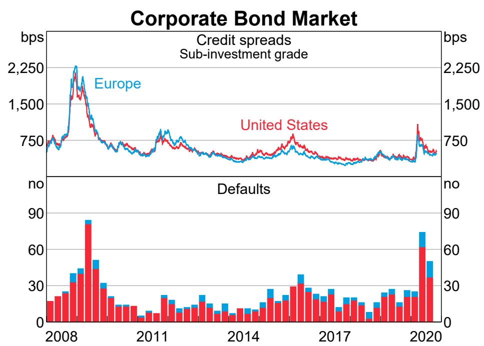
Equity prices have been volatile but remain substantially above their March lows

Global equity prices are generally little changed since the previous *Statement*, and they remain around 40 per cent higher than their trough in March (Graph 2.10). Equity prices temporarily fell sharply in parts of Europe after a number of countries reintroduced strict lockdowns to contain rising COVID-19 cases. In the United States and Japan, equity prices remain around their peaks prior to the pandemic; most other indices are around 15–20 per cent below their pre-pandemic levels (Table 2.1).

Higher global equity prices have been supported by a nascent recovery in corporate earnings. While profitability remains much lower than a year ago, corporate earnings in the United States and Europe are estimated to have risen over the September quarter and are expected to increase further in the months ahead. Corporate earnings have been aided by the significant easing of fiscal and monetary policies, which has supported economic activity while helping to reduce uncertainty and increase risk appetites. However, the volatility of equity prices has remained above long-run averages, in part reflecting rising COVID-19 infections in some parts of the world and uncertainty in the United States over the outcome of the US election and prospects for further fiscal stimulus (Graph 2.11).

A decline in equity prices in September reflected concerns about elevated valuations in equity markets, especially of technology stocks in the United States. The US technology sector has rallied by 65 per cent since its trough in March, and is 15 per cent higher than its pre-pandemic level (Graph 2.12). While the increase in technology stocks is consistent with greater demand for digital goods and services during

Graph 2.9

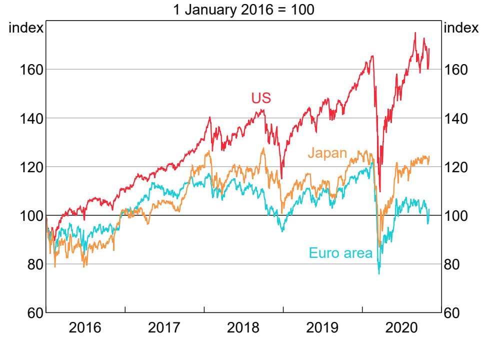


Sources: ICE Data is used with permission; S&P Global Market Intelligence the pandemic, the increase in US technology equity prices has significantly outpaced growth in forward earnings estimates for the sector.

Graph 2.10

Equity Prices

1 January 2016 = 100

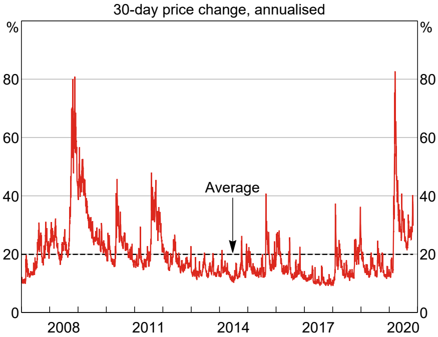


Source: Bloomberg

Graph 2.11

Implied Volatility for US Equity Prices

30-day price change, annualised



Source: Bloomberg

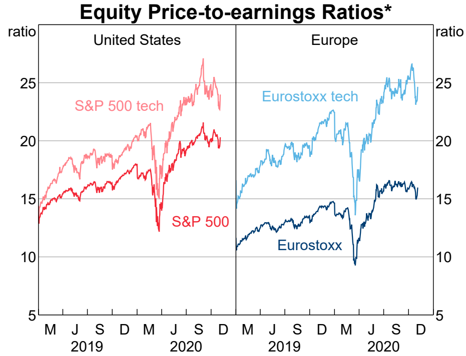
Bank share prices have continued to underperform broader equity markets because the economic impact of the pandemic is expected to reduce banks' profitability for some time (Graph 2.13). Provisions for future loan losses increased significantly over the first half of the year, contributing to sharp falls in earnings, before returning to pre-COVID-19 levels in the September quarter (Graph 2.14). Lower interest rates have also weighed on bank profitability by reducing net interest margins. In contrast, banks' investment banking revenues have been buoyed by higher market volatility and increased debt and equity issuance. Overall, banks remain highly capitalised, and continue to support the economic recovery by extending credit to households and businesses.

The US dollar has depreciated significantly over a number of months

After having appreciated sharply in March, the US dollar has depreciated significantly on a trade-weighted (TWI) basis and is around levels observed prior to the onset of the pandemic (Graph 2.15). The depreciation has been consistent with the easing in global risk aversion since March as well as US interest rates having fallen by more than those in other major advanced economies. The US dollar is little

Graph 2.12

Equity Price-to-earnings Ratios*



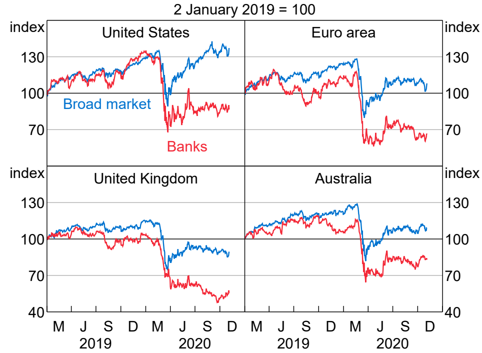
* Calculated using consensus forecasts for next calendar year earnings

Source: Bloomberg

Graph 2.13

Bank Equity Prices

2 January 2019 = 100



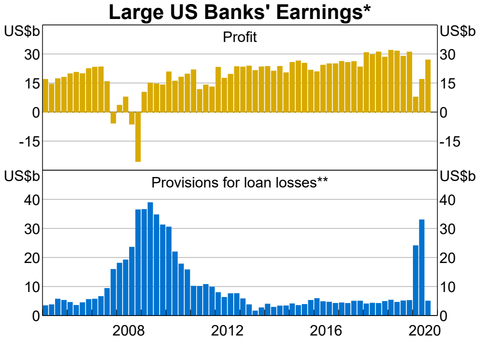
Source: Bloomberg

changed from where it was at the time of the previous *Statement*.

The euro has appreciated over a number of months and remains around its highest level since 2014, supported by the agreement on the EU recovery fund earlier in the year. In response to the appreciation of the euro, the ECB has reiterated that it would carefully assess developments in the exchange rate and its implications for inflation, but that it does not target the exchange rate. The Japanese yen also remains at a relatively high level, despite drifting lower over recent months. The currencies of a number of advanced economies have continued to track US equity markets relatively closely. This could reflect equity markets capturing information about changes in risk and the economic outlook at a time when sovereign bond yields are anchored at very low levels.

Graph 2.14

Large US Banks' Earnings*

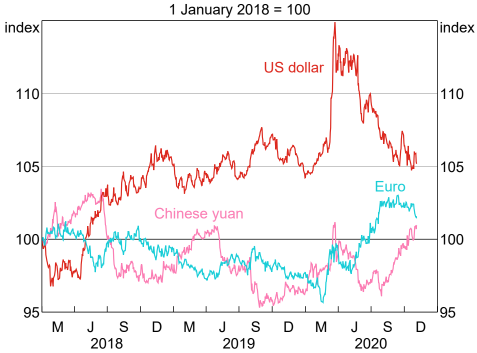


* Includes the 6 largest US banks
** Commercial banks only
Source: Bloomberg

Graph 2.15

Trade-weighted Exchange Rates

1 January 2018 = 100



Sources: BIS; Bloomberg; Board of Governors of the Federal Reserve System

The Australian dollar has depreciated alongside a further easing in domestic monetary policies

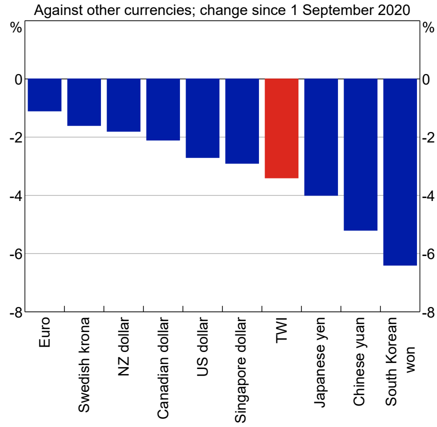
The Australian dollar has experienced a broad-based depreciation since the start of September, depreciating by 3½ per cent on a TWI basis (Graph 2.16). It is now back around levels observed at the start of the year.

The depreciation of the Australian dollar over the past two months was associated with declines in interest rates in Australia relative to those of other major advanced economies. This occurred as market participants increasingly anticipated further policy easing by the Reserve Bank at the November Board meeting (see Domestic Financial Conditions). Commodity prices have also decreased in the past couple of months (Graph 2.17). Following this recent depreciation, the level of the Australian dollar is a touch lower than historical relationships with the terms of trade and interest rate differentials would suggest.

Graph 2.16

Australian Dollar

Against other currencies; change since 1 September 2020



Sources: Bloomberg; RBA

Australia experienced a net capital outflow in the June quarter

Australia recorded a net capital outflow in the June quarter, mirroring the current account surplus (Graph 2.18). Net outflows were consistent with the decline in outstanding issuance of debt abroad by Australian banks (see Domestic Financial Conditions). In contrast, there were inflows related to foreign purchases of Australian Government securities and Australian superannuation and investment funds selling foreign equities for liquidity purposes.

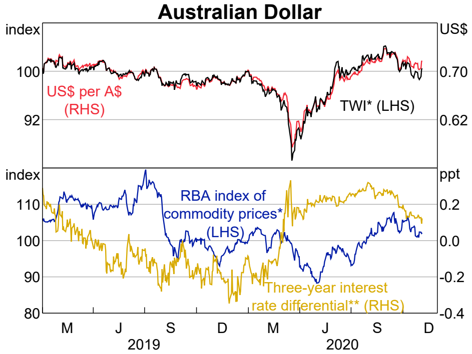
Australia's net foreign liability position remains around its lowest level as a per cent of GDP since the early 1990s (Graph 2.19). A small increase in the June quarter was driven by a narrowing in Australia's net foreign equity asset position. This in turn owed mostly to valuation effects associated with the appreciation of the Australian dollar, which reduces the Australian dollar value of foreign equity portfolios. This follows a number of years over which Australian equity investment abroad exceeded foreign equity investment in Australia and the net foreign equity position widened.

Financial conditions have been stable for most, but not all, emerging markets

With a few notable exceptions, financial conditions in emerging market economies (EMEs) have been stable in recent months, aided by accommodative domestic policy settings and very accommodative global financial conditions. Government bond yields remain around record lows for most EMEs, equity prices have for the most part been steady and there have been modest portfolio inflows into most regions since June (Graph 2.20). Spreads on US dollar-denominated government and corporate bonds have narrowed further over recent months, although they remain above their pre-COVID levels. The currencies of some EMEs in Asia have appreciated against the US dollar, alongside the economic recovery in China, while exchange rates of most other EMEs have depreciated. In

Graph 2.17

Australian Dollar



* Indexed to 1 January 2020 = 100

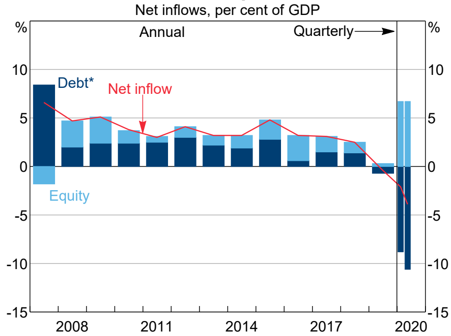
** Spread to the United States, Japan and Germany, weighted by GDP

Sources: Bloomberg; RBA

Graph 2.18

Australian Capital Flows

Net inflows, per cent of GDP



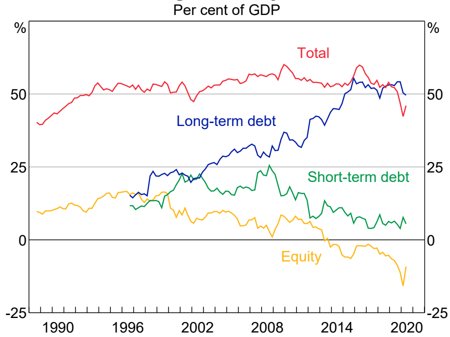
* Adjusted for US dollar swap facility in 2008-09 & 2020; includes reserve assets, other central bank flows and derivatives

Sources: ABS; RBA

Graph 2.19

Net Foreign Liability Position

Per cent of GDP



Sources: ABS; RBA

particular, the Turkish lira has depreciated significantly, reflecting concerns about rising geopolitical tensions and macrofinancial vulnerabilities.

Though financial conditions have improved substantially since the onset of the pandemic, EMEs remain vulnerable to the ongoing health and economic crisis. This is particularly the case for those EMEs that entered the pandemic with weak economic growth, large fiscal deficits and substantial external financing. A few EMEs that are particularly vulnerable continue to face financial conditions that are noticeably tighter than at the start of the year, in particular South Africa and Turkey.

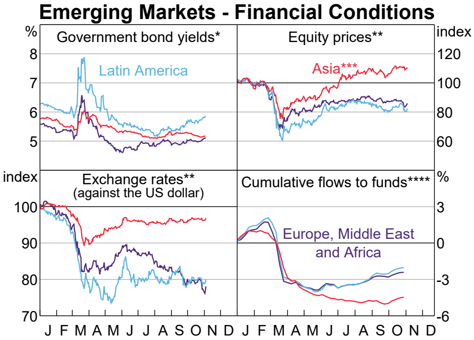
Emerging market central banks have maintained accommodative policy settings (see 'Box B: The Policy Response of Central Banks in Emerging Market Economies to COVID-19'). Policy rates have generally been unchanged at low levels since August (Graph 2.21). Indeed, a number of EME central banks have indicated that the scope for further policy easing is limited, noting concerns about the effect of further reductions in interest rates on exchange rate stability, inflation and financial stability. Central bank purchases of government bonds have generally been modest in recent months. Most EME's appear to have largely scaled back foreign exchange intervention to support their currencies, while some central banks in Asia have actually been accumulating reserves to limit exchange rate appreciation.

Multilateral measures have continued to support low-income countries and EMEs during the crisis. The International Monetary Fund (IMF) is providing financing to low-income countries and EMEs, and has extended to April 2021 a temporary increase in its limits on emergency lending; this will enable members to apply for further emergency financing if needed (Graph 2.22). In addition, over 40 low-income countries will continue to receive debt forbearance through the G20's Debt Service Suspension Initiative, which has been extended until mid 2021.

Given the scale of the crisis, there is widespread acknowledgement of the need to transition from emergency support to larger and longer-term assistance. As part of this process, the IMF is considering how to adapt its longer-term conditional lending programs to the specific challenges of this crisis; for example, by temporarily front-loading payments and introducing more focus on short-term economic stabilisation. The international community has also recognised that in some cases debt restructuring may be necessary, particularly for

Graph 2.20

Emerging Markets - Financial Conditions

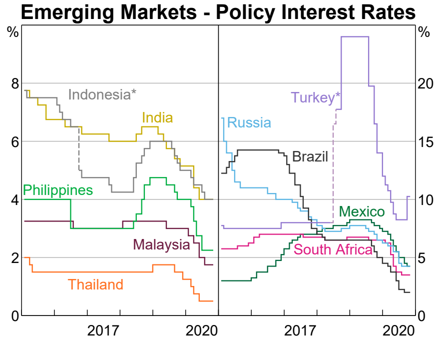


* Local currency bonds, weighted by market value
** 1 Jan 2020 = 100
*** Excluding China
**** Per cent of assets under management; includes flows to bond and equity funds

Sources: Bloomberg; EPFR Global; IMF; JPMorgan; MSCI; RBA

Graph 2.21

Emerging Markets - Policy Interest Rates



* Dashed lines indicate a change in the monetary policy framework and/or to the rate used as the official policy rate

Source: Central banks

low-income countries. Efforts are already underway to improve the sovereign debt restructuring process, including the development of a shared framework among G20 countries that is intended to enhance creditor cooperation.

China's monetary policy remains accommodative but financial conditions have tightened as the economy recovers

Policymakers in China continue to support economic growth and employment at the same time as limiting the build-up of financial stability risks. To that end, policymakers have overseen a tightening of conditions in financial markets since May. Government and corporate bond yields have risen to around pre-pandemic levels, interest rates in money markets have increased, and the People's Bank of China (PBC) has reduced its provision of liquidity (Graph 2.23).

Nevertheless, financial conditions more broadly remain accommodative. In particular, equity prices have risen substantially this year and bank lending rates remain low, reflecting reductions in the PBC's medium-term lending facility rate earlier this year, which flowed through to declines in the Loan Prime Rate (the reference rate for most bank loans in China). Local banks have also been instructed to reduce their interest margins to keep lending rates low.

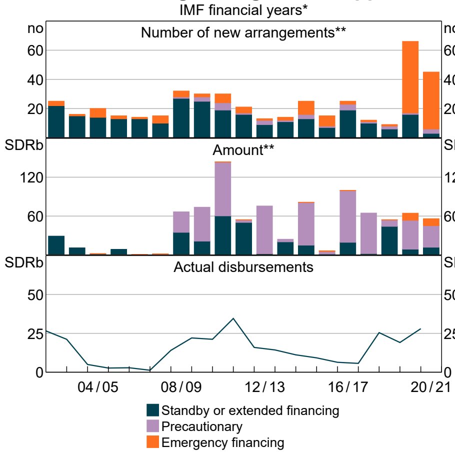
Growth in total social financing (TSF) has increased in year-ended terms despite some moderation in recent monthly growth rates (Graph 2.24). This remains consistent with the stated goal of authorities that TSF growth in 2020 be 'notably higher than in 2019'. The faster pace of growth this year partly reflects stronger growth in business loans, equity issuance and corporate bond issuance. In addition, government bond issuance has been strong at both the local government and central government levels this year consistent with the scale of China's government deficit.

Credit supply continues to be targeted towards the private sector and smaller enterprises, and away from the riskier and more highly leveraged sectors such as real estate. Policymakers also continue to focus on ensuring that credit is flowing through the less opaque and better regulated parts of the financial system (the banks and financial markets), and less through shadow financing channels. In addition, authorities remain mindful of the potential

Graph 2.22

IMF Financing Arrangements Approved

IMF financial years*



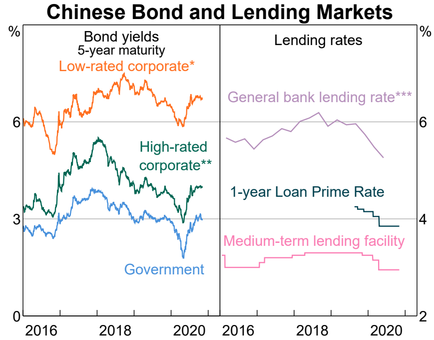
* IMF financial year runs from May to April; the observation for 2020/21 is for May to September 2020

** Excludes augmentation of existing arrangements

Sources: IMF; RBA

Graph 2.23

Chinese Bond and Lending Markets



* Based on domestically rated AA- corporate bonds

** Based on domestically rated AAA corporate bonds

*** Business rate proxy

Sources: Bloomberg; CEIC data; RBA

build-up of risks in the banking sector (see RBA (2020), *Financial Stability Review*, October).

The Chinese renminbi has appreciated

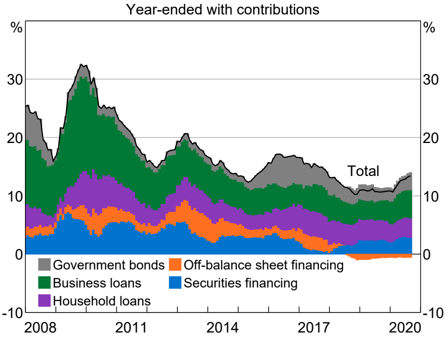
The Chinese renminbi has appreciated over recent months and is around 5 per cent higher than at the start of the year (Graph 2.25). The appreciation has occurred alongside the broad-based depreciation in the US dollar, the rebound in Chinese economic activity, and continued inflows to Chinese bond markets. These inflows are likely to have been supported by Chinese interest rates rising relative to those of advanced economies. Inflows related to China's inclusion in some global fixed income benchmarks also appear to have provided support to the value of the renminbi. Geopolitical and trade tensions remain key factors that could influence the currency.

In October, the PBC removed the requirement for holding reserves against some foreign exchange derivatives that would benefit from a depreciation in the renminbi. Some market reports suggested that the change signalled some concern about the recent pace of appreciation, while others highlighted it was consistent with the ongoing liberalisation of the currency. ✠

Graph 2.24

China – Total Social Financing Growth*

Year-ended with contributions

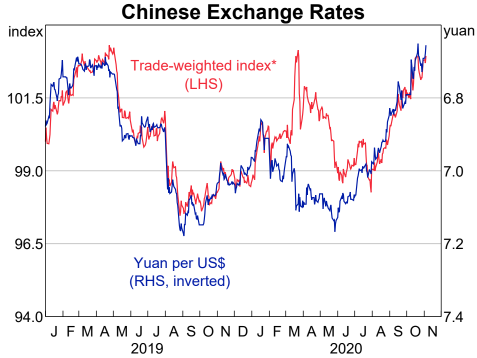


* Net government bond issuance includes local government bond issuance to pay off debt previously included in TSF, and uses RBA estimates prior to 2016

Sources: CEIC Data; RBA

Graph 2.25

Chinese Exchange Rates



* Indexed to 1 January 2019=100

Sources: Bloomberg; China Foreign Exchange Trade System; RBA