3. Domestic Financial Conditions

Domestic financial conditions remain accommodative for most households and large businesses. Financial market prices suggest that the cash rate is expected to be lowered by 25 basis points later this year, with another 25 basis points reduction expected by early next year. Government bond yields have declined since the beginning of 2019 to be around record lows, contributing to a reduction in corporate bond yields. Money market rates and spreads to overnight index swaps (OIS) have also fallen since the start of the year. As a result, banks' funding costs have declined. While housing and business interest rates are very low, growth in housing credit slowed further, consistent with weak demand for housing and the decline in dwelling prices. Growth in business debt remains higher than the average of recent years, driven entirely by lending to large businesses. In contrast, borrowing conditions for small businesses remain tight. Australian equity prices have risen across all sectors since the start of the year, broadly in line with overseas markets. The Australian dollar is around the lower end of its narrow range of the past few years.

Investors expect the cash rate to be lowered later this year

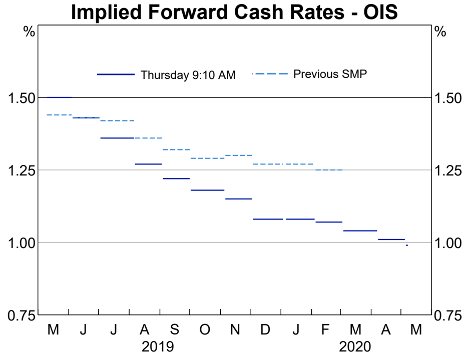
The Reserve Bank has maintained the cash rate target at 1.5 per cent since August 2016. Weaker-than-expected economic data released since late 2018 have led investors to reassess their cash rate expectations. Financial market prices imply that the cash rate is expected to be lowered by 25 basis points later this year, with another 25 basis points reduction expected by early next year (Graph 3.1).

Government bond yields have declined to historically low levels

Yields on Australian Government Securities (AGS) declined since the start of the year across all maturities, with 10-year AGS yields moving close to historical lows and currently around 1.75 per cent. This partly reflected a decline in government bond yields internationally, but also followed weaker-than-expected domestic economic data. The slope of the yield curve, as measured by the spread between 10-year and 2-year AGS yields, has remained positive at around 40 basis points. AGS yields have fallen by more than US Treasury yields, resulting in the difference between 10-year US Treasury and AGS yields widening to around 75 basis points (Graph 3.2).

Graph 3.1

Implied Forward Cash Rates - OIS



Sources: RBA; Tullet Prebon (Australia) Pty Ltd

Short-term money market rates have fallen

Interest rates in the markets for bank bills, repurchase agreements (repo) and foreign exchange (FX) swaps have fallen since the beginning of the year. The spread of 3-month bank bills relative to OIS fell from a peak of around 60 basis points around the turn of this year to around 25 basis points, its lowest level since late 2017 (Graph 3.3). Similarly, the cost of raising US dollar funding and then converting these funds into Australian dollars for a short term in the foreign exchange swap market declined by about 40 basis points since the beginning of the year, to around 35 basis points over OIS. Repo rates also declined to be around 20 basis points over OIS. Meanwhile, the cash rate has continued to trade at the Reserve Bank Board's target.

Banks' funding costs have declined

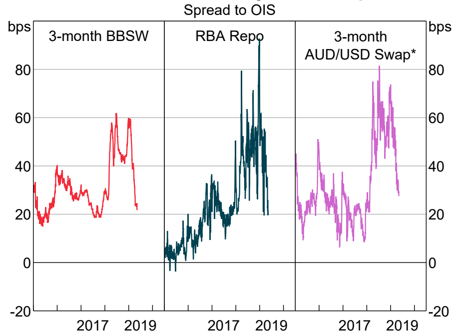
The increase in banks' wholesale funding costs in 2018 has been fully unwound given the decline in interest rates in short-term funding markets over the course of this year. Also, the interest rates at which banks raise long-term debt funding have declined to record lows, as these yields have followed the decline in government bond yields (Graph 3.4). The spreads of major bank bond yields to reference rates have also narrowed in recent months; secondary market spreads on 3-year bonds issued in the Australian market are currently around 20 basis points tighter than at the start of the year.

Moreover, banks have reduced interest rates on retail deposits, which account for around a third of banks' non-equity funding. Over the past year, the major banks have reduced their retail deposit rates for some at-call deposits and for term deposits for terms longer than one year. On average, retail deposit rates are at a low level,

Graph 3.3

Australian Dollar Money Market Spreads

Spread to OIS



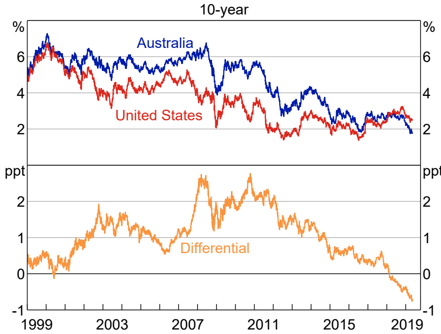
* Implied cost of offshore issuance in US dollars swapped back to Australian dollars

Sources: ASX; Bloomberg; RBA

Graph 3.2

Government Bond Yields

10-year

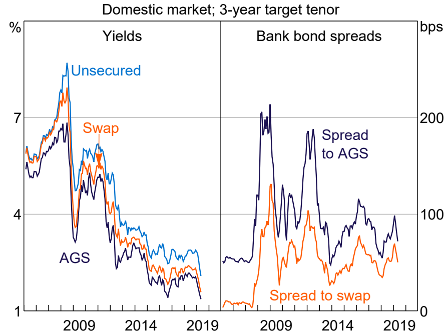


Sources: Bloomberg; RBA

Graph 3.4

Major Banks' Bond Pricing

Domestic market; 3-year target tenor



Sources: Bloomberg; RBA

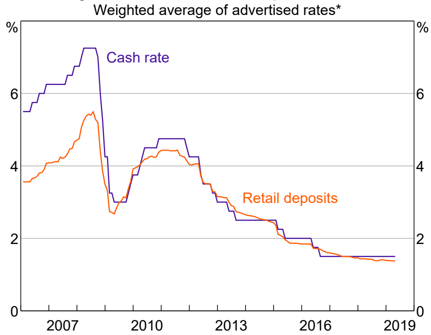
consistent with the low level of market interest rates (Graph 3.5).

The bulk of the major banks' deposits (including both retail and wholesale deposits) are estimated to receive an interest rate of over 1 per cent; less than 10 per cent of deposits receive no interest (Graph 3.6). Most of the deposits that receive an interest rate that is below the cash rate (of currently 1.5 per cent) are at-call deposits, while most of the deposits that receive an interest rate above this rate are term deposits.

Graph 3.5

Major Banks' Retail Deposit Rates

Weighted average of advertised rates*



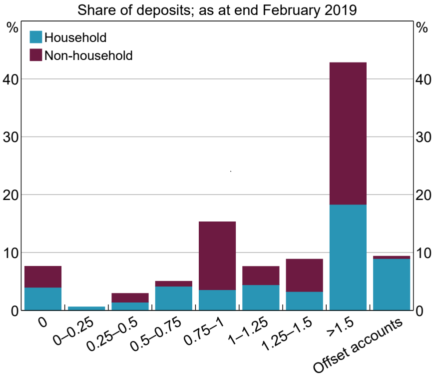
* RBA estimates

Sources: APRA; Canstar; major banks' websites; RBA

Graph 3.6

Major Banks' Deposits by Interest Rate*

Share of deposits; as at end February 2019



* Interest rates were reported as weighted average rates for various deposit product types

Sources: Major banks; RBA

Banks continue to issue bonds at low yields

Australian banks continued to issue bonds at a similar pace to previous years, with around $40 billion issued in the first four months of the year (Graph 3.7). However, net issuance has been lower than in 2018 because the volume of scheduled maturities is higher. Issuance since the start of the year has featured a relatively high share of domestic issuance and covered bonds. This was associated with the period of higher volatility in global financial markets around the turn of the year.

Issuance of residential mortgage-backed securities (RMBS) over the year to date has been in line with the average of recent years, but a little lower than the high level seen in 2017 (Graph 3.8). Recent issuance has been driven by non-bank lenders and the major banks, while the non-major banks have been absent from the market this year.

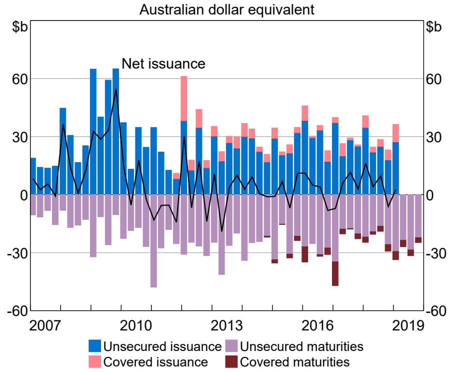
Interest rates on housing loans are little changed at low levels

Average housing interest rates are little changed from the levels seen in August 2018, despite increases in most lenders' standard variable

Graph 3.7

Australian Banks' Bond Issuance

Australian dollar equivalent



Sources: Bloomberg; RBA

rates (SVRs) of around 15 basis points since that time (Table 3.1). Most authorised deposit-taking institutions (ADIs) increased their SVRs at least once between mid 2018 and early 2019, citing that this was in response to higher funding costs at the time. Despite the rise in SVRs, data from the Reserve Bank's Securitisation Dataset suggest that outstanding variable interest rates increased by only a few basis points from their trough in August 2018 to March 2019, with marginally higher increases for investor and interest-only loans (Graph 3.9 and Graph 3.10). The smaller rise in average rates actually paid relative to the increase in SVRs reflects the fact that new loan rates remain well below the rates on outstanding loans. Banks' profit reports and liaison confirm that the SVR increases have not fully flowed through to average housing interest rates because customers have refinanced or switched from interest-only loans to principal-and-interest loans with lower interest rates.

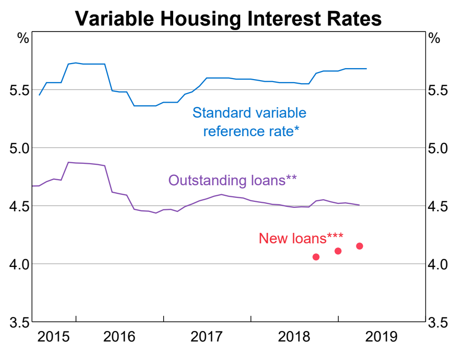
In recent months, several lenders decreased their advertised rates on fixed-rate housing loans, consistent with declines in fixed interest rates in wholesale markets in response to lower market expectations for the cash rate. Data from the Securitisation Dataset suggest that average interest rates on outstanding fixed-rate mortgages have decreased by around 10 basis points over the past year. Housing loans with fixed interest rates account for around 20 per cent of outstanding housing credit.

Credit growth has slowed, driven by slower housing credit growth

Total credit growth has slowed to 3¼ per cent on a six-month annualised basis, driven largely by a slowing in housing credit growth (Table 3.2 and Graph 3.11). Business credit growth has also eased of late, but it remains around 4½ per cent on a six-month annualised basis.

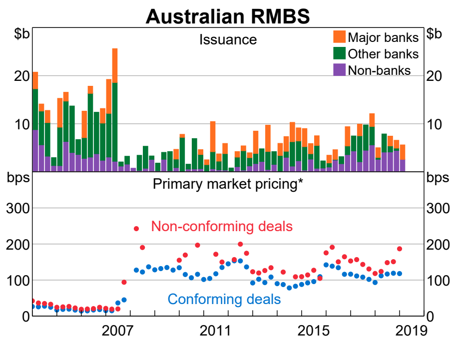
Growth in credit extended to owner-occupiers has declined to 4½ per cent on a six-month

Graph 3.9



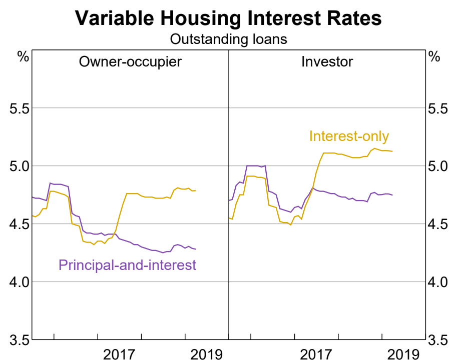
* Average across major banks' rates; data to April
** Data to March; data from the Securitisation Dataset
*** Average new variable lending rate based on APRA quarterly data; the last observation is preliminary
Sources: APRA; major banks' websites; RBA; Securitisation System

Graph 3.8



* Face-value weighted quarterly average of the primary market spread to bank bill swap rate for AAA rated notes
Sources: Bloomberg; KangaNews; RBA

Graph 3.10



Sources: RBA; Securitisation System

Table 3.1: Intermediaries' Housing Lending Rates

March 2019

	Interest rate Per cent	Change since August 2018 Basis points	Change since March 2018 Basis points
Variable principal-and-interest rate			
– Owner-occupier	4.28	2	1
– Investor	4.75	5	3
Variable interest-only rate			
– Owner-occupier	4.79	6	6
– Investor	5.12	5	5
Average outstanding variable rate	4.51	2	–1
Fixed rate			
– Owner-occupier	4.07	–11	–14
– Investor	4.26	–7	–9
Average outstanding rate (fixed and variable)	4.46	0	–2

Sources: RBA; Securitisation System

Table 3.2: Financial Aggregates

Percentage change(a)

	Three-month ended annualised		Six-month ended annualised	
	Dec 2018	Mar 2019	Sep 2018	Mar 2019
Total credit	3.6	3.1	4.6	3.3
– Housing	3.5	3.1	4.7	3.3
– Owner-occupier housing	5.0	4.3	6.7	4.7
– Investor housing	0.5	0.5	0.9	0.5
– Personal	–3.9	–4.0	–1.6	–3.9
– Business	4.8	4.2	5.4	4.5
Broad money	1.1	9.9	2.4	5.4

(a) Seasonally-adjusted and break-adjusted

Sources: ABS; APRA; RBA

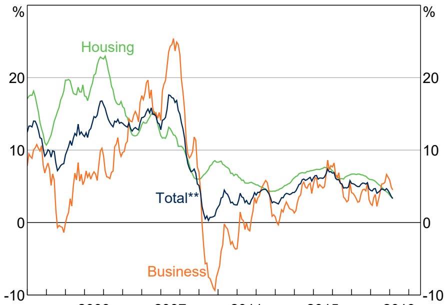
annualised basis, driven by a slowing in the growth of credit extended by the major banks and to a lesser extent by other Australian ADIs (Graph 3.12). However, monthly growth in credit extended to owner-occupiers has stabilised over recent months. Housing loan approvals for owner-occupiers remain well below their mid-2017 peak (Graph 3.13).

Housing credit growth for investors has also stabilised over recent months at low levels. Credit extended by the major banks to investors has contracted since mid 2018, consistent with a decline in investor housing loan approvals by these banks. However, investor credit extended by other financial institutions has been a little stronger and more than offset the reduction of investor lending by the major banks in recent months. Loan approvals to investors are around half their peak in early 2017.

Graph 3.11

Credit Growth by Sector*

Six-month-ended annualised



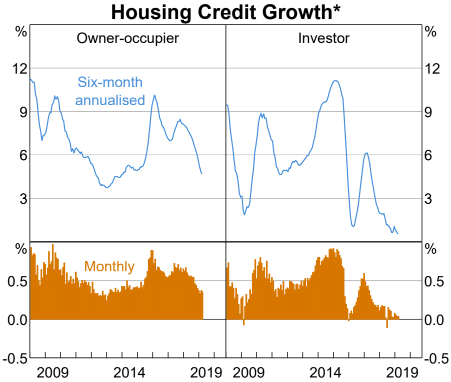
* Seasonally adjusted and break-adjusted; including securitisation

** Includes housing, personal and business credit

Sources: ABS; APRA; RBA

Graph 3.12

Housing Credit Growth*



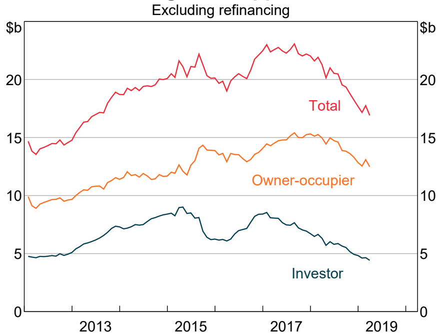
* Seasonally adjusted and break-adjusted

Sources: APRA; RBA

Graph 3.13

Housing Loan Approvals*

Excluding refinancing



* Seasonally adjusted

Sources: APRA; RBA

Demand for housing credit remains weak …

The slowing in credit growth is consistent with less demand for housing finance. The fall in housing prices has reduced the demand for credit, particularly from potential investors who are especially sensitive to expectations of capital losses. Liaison with major banks and mortgage brokers indicates that they have been receiving significantly fewer loan applications over the past year.

… but credit conditions are also tighter than they have been for some time

Housing credit conditions are tighter than they have been for some time following the strengthening of lending policies and practices over recent years. Over the past year or so, lenders have focussed on verifying expenses in loan applications more thoroughly. This has reduced the maximum loan size available to many households, though only a small share of households borrow close to the maximum amount that they are offered. Liaison with banks suggests that it generally takes a few days longer for loans to be approved compared with earlier years, but that most people who apply for a loan can still obtain the amount they want to borrow.

More recently, the transition to comprehensive credit reporting (CCR) is providing banks with more complete information on borrowers' debts and credit limits. CCR was introduced for credit cards from late 2018, and additional information on personal credit and mortgages will be made available to lenders over 2019. On the one hand, CCR could be expected to reduce maximum loan sizes for some prospective borrowers by better identifying applicants' other debts or debt limits that may not have been disclosed. On the other hand, CCR will provide lenders with greater information about applicants' credit history, and this reduction in uncertainty could support banks' willingness to lend.

Large business funding conditions remain accommodative …

Growth in a broad measure of business debt has been higher than the average of recent years, reflecting an increase in credit extended by foreign banks and the major Australian banks (Graph 3.14 and Graph 3.15). All of the growth in business debt over the past year or so has been accounted for by large businesses, with lending to small businesses declining over this period.

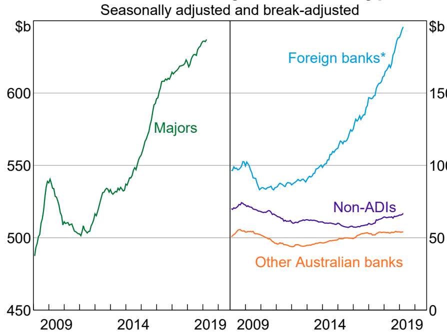
After increasing last year, business loan approvals have eased back over the past six months. This has been driven by a decline in business loan approvals by the major banks. Business loan approvals for the purchase of existing residential property have fallen since late 2017, particularly in NSW and Victoria. This is consistent with banks tightening their lending standards for residential property investment. In contrast, loan approvals for the purchase of commercial property have picked up, primarily for the purchase of office and other non-residential buildings.

The pace of bond issuance by non-financial corporations has increased compared with the second half of 2018 (Graph 3.16). This reflects an increase in issuance by resource-related corporations, particularly those in the energy and utilities sectors. Overall, funding conditions for large corporations remain accommodative, with secondary market yields remaining around historically low levels.

Graph 3.15

Business Credit by Institution Type

Seasonally adjusted and break-adjusted

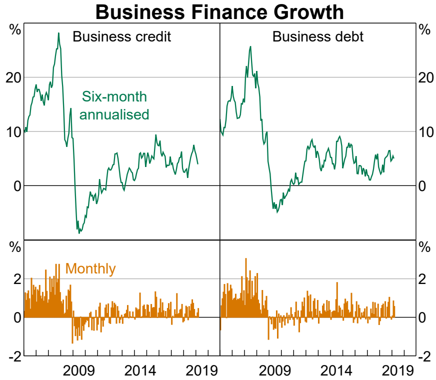


* Not all foreign banks report to APRA

Sources: APRA; RBA

Graph 3.14

Business Finance Growth

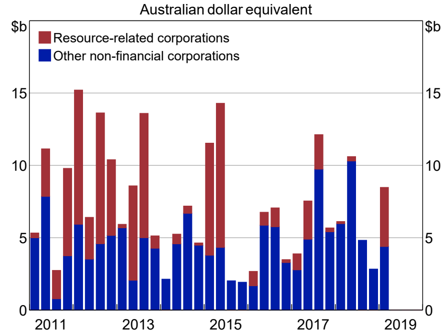


Sources: APRA; RBA

Graph 3.16

Australian Corporate Bond Issuance

Australian dollar equivalent



Sources: Bloomberg; RBA

… but credit conditions for small businesses have tightened

Small businesses are reporting in surveys that they are finding it more difficult to obtain finance (Graph 3.17). Liaison with banks suggested that the heightened verification of expenses for lending to consumers (including lending for housing) has been extended to many small businesses given the difficulty in separating personal from business finances for many small businesses. This appears to have impinged on small business lending, given that small businesses find it harder to provide evidence that they can service a loan as their income tends to be volatile. In addition, lower housing prices are likely to weigh on lending to small businesses, since around half of small business loans are estimated to be secured with residential property. In addition to these supply-side constraints, liaison with banks suggests that demand for loans from small businesses has decreased, with applications for loans falling over the past year.

Interest rates on business loans are low

Interest rates for loans to large businesses decreased a little in the March quarter since around three-quarters of such loans are closely linked to bank bill swap rates (BBSW). Large business interest rates are at low levels (Graph 3.18 and Table 3.3).

Lending rates on outstanding loans to small businesses have been little changed for much of the past year, as small business rates are generally not directly linked to BBSW rates. Small business lending rates are noticeably higher than interest rates for large businesses. While this partly reflects the higher default rates associated with small business loans, the difference between small and large business loan rates increased following the global financial crisis and has been maintained since then.

Australian equity prices have increased this year

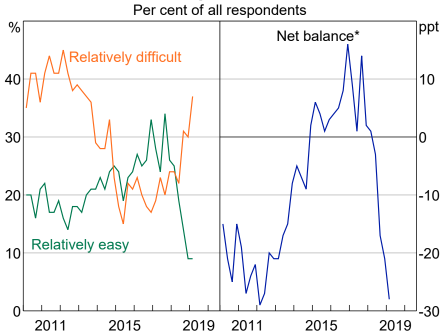
The ASX 200 equity index is around 11 per cent higher than at the end of 2018, and has performed broadly in line with overseas markets when dividend payments are taken into account (Graph 3.19). Market volatility picked up at the start of the year, but has since declined back to relatively low levels.

Share prices have risen across all industry sectors since the start of the year. Share prices of

Graph 3.17

Small Business' Perception of Access to Finance

Per cent of all respondents



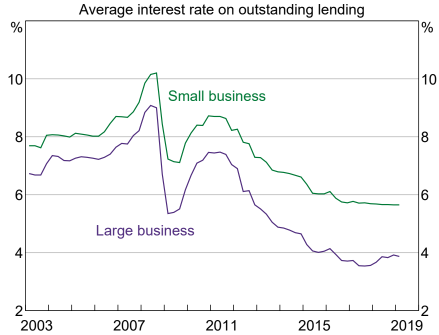
* Net balance is the difference between the percentage of firms indicating access is relatively easy and the percentage of firms indicating access is relatively difficult

Sources: RBA; Sensis

Graph 3.18

Variable Business Lending Rates*

Average interest rate on outstanding lending



* RBA estimates

Sources: APRA; RBA

Table 3.3: Intermediaries' Business Lending Rates
March 2019

	Interest rate Per cent	Change since March 2018 Basis points
Small business[(a)]		
– Average outstanding variable rate	5.65	–3
– Average outstanding fixed rate	5.24	0
Large business[(b)]		
– Average outstanding variable rate	3.87	20
– Average outstanding fixed rate	3.69	7

(a) Loans under $2 million
(b) Loans over $2 million
Sources: APRA; RBA

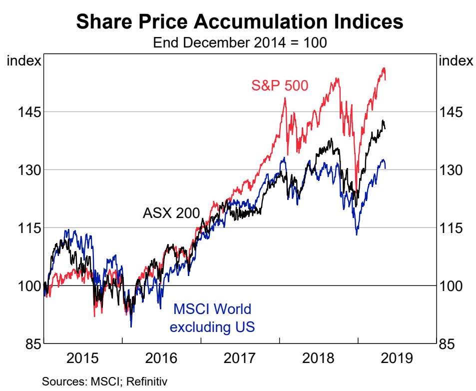
resources companies have been supported by higher iron ore prices following supply disruptions in Brazil (Graph 3.20). In contrast, banks' share prices have increased by less, following mixed profit reports from the banks and weakness in global banking stocks.

Earnings of listed companies were little changed

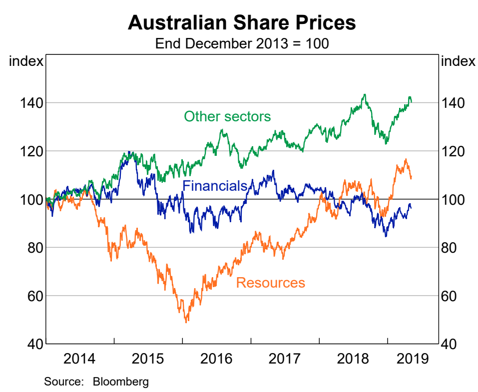
Underlying earnings of listed corporations were little changed overall in the half year to December relative to the same period a year earlier (Graph 3.21). Earnings increased for energy companies, following increases in oil prices, and for non-bank companies in the finance sector, such as insurance companies. This was offset by lower earnings for real estate companies and in the materials sector. Results were broadly in line with analysts' expectations, although these had been downgraded in the lead-up to the profit reporting season. Headline profits increased, partly due to proceeds from asset sales in the resources sector; some of these proceeds were distributed to shareholders through special dividend payments and share buybacks.

Gearing at listed corporations increased slightly in the half year to December (Graph 3.22). This followed three years of declines in gearing,

Graph 3.19

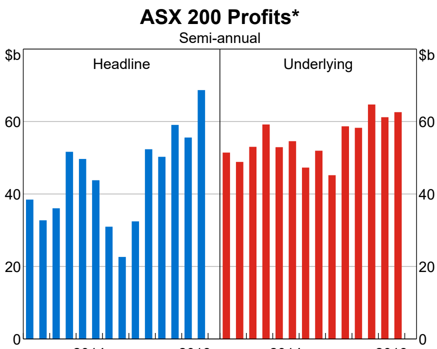


Graph 3.20



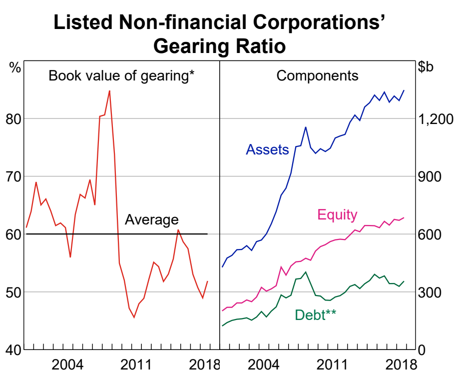
driven by deleveraging of the major miners. These companies have indicated that they intend to prioritise returning capital to shareholders over debt reduction. In contrast, gearing at real estate companies increased. This reflected relatively slow asset growth due in part to lower revaluation gains on property in a softer residential property market.

Graph 3.21



* Results for companies with reporting dates in the half are rolled forward.
Sources: Bloomberg; Company reports; Morningstar; RBA

Graph 3.22



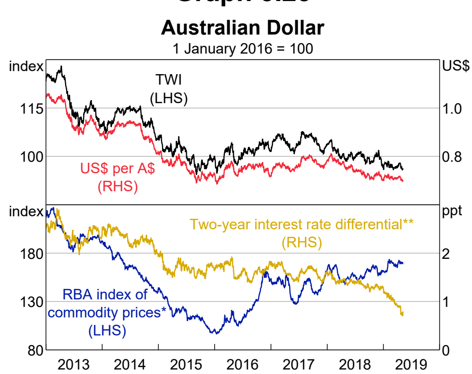
* Ratio of gross debt to equity, excludes foreign-domiciled companies
** Debt only includes short-term and long-term loans and bonds payable; not equivalent to total liabilities
Sources: Morningstar; RBA

The Australian dollar is around the lower end of its narrow range of the past few years

The Australian dollar is little changed since the start of the year on a trade-weighted (TWI) basis (Graph 3.23). Over the past couple of months, the Australian dollar has been around the lower end of its narrow range of the past few years. As is the case for the currencies of other advanced economies, measures of volatility in the Australian dollar remain at a low level.

Over time, movements in the Australian dollar tend to be related to developments in commodity prices (and the terms of trade more generally) and interest rate differentials. Since the start of the year, as in recent years, these two forces have been working in offsetting directions; the RBA Index of Commodity Prices has increased while Australian Government bond yields have declined relative to those in major markets. Over the past couple of years the decline in Australian Government bond yields has been most pronounced relative to the United States, although more recently it has become broadly based (Graph 3.24). The net effect of commodity prices and interest rate differentials has been consistent with the

Graph 3.23



* With spot bulks
** Spread to equally weighted nominal yields in Germany, Japan, the United Kingdom and the United States
Sources: Bloomberg; RBA

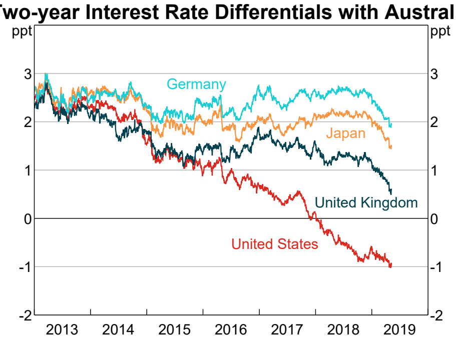
Australian dollar remaining within a narrow range over the past few years on a TWI basis.

Net capital inflows to Australia continue to be modest (Graph 3.25), consistent with the relatively low level of the current account deficit (see 'Domestic Economic Conditions' chapter). At the sectoral level, there have been increased flows of foreign investment to the non-mining corporate sector in the past few years, partly offsetting a decline in flows to the mining sector. The banking sector experienced modest inflows in 2018. This largely reflected bond inflows in the first half of the year, in line with positive net offshore bond issuance by Australian banks; more recently both have slowed. In contrast, the 'other' financial sector has continued to experience capital outflows, largely driven by flows from superannuation funds. This is consistent with their ongoing accumulation of foreign assets, in particular, foreign equities.

Australia's net foreign liability position has declined as a share of GDP over recent years, to be around its lowest level since 2002 (Graph 3.26). This reflected a decline in net capital inflows at a time when the nominal value of output has been increasing. The value of the net foreign liability position is little changed since mid 2016. The accumulation of liabilities resulting from net capital inflows has been largely offset by asset valuation effects, whereby the value of Australian assets held abroad has increased relative to Australia's liabilities with the rest of the world. Over the past year, the depreciation of the Australian dollar has also increased the value of Australia's foreign assets (which are largely unhedged) relative to foreign liabilities (which are mostly denominated in Australian dollars or hedged against a depreciation of the Australian dollar).

Graph 3.24

Two-year Interest Rate Differentials with Australia

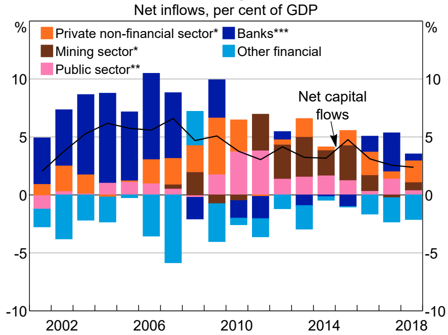


Sources: Bloomberg; RBA

Graph 3.25

Australian Capital Flows

Net inflows, per cent of GDP



* Prior to 2007 the mining sector is included in the private non-financial sector

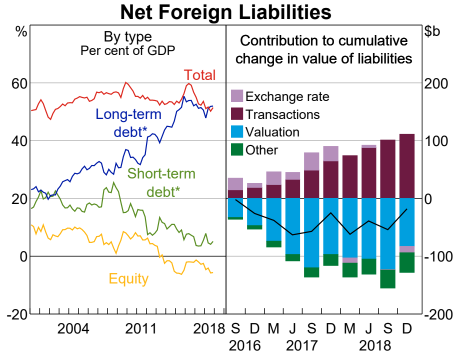
** Excludes official reserves and other RBA flows

*** Adjusted for US dollar swap facility in 2008 and 2009

Sources: ABS; RBA

Graph 3.26

Net Foreign Liabilities



* Short-term includes debt with a residual maturity of one year or less; long-term includes all other debt

Sources: ABS; RBA