Overview

Global economic growth has slowed and asset prices remain elevated

Growth in the major advanced economies, and the global economy more broadly, moderated in the second half of 2018 and into 2019. Growth forecasts have also been revised down and there are risks of a sharper downturn. This follows a period of above-trend growth that had supported financial stability as borrowers were well placed to meet their debt obligations and banks' profits helped them increase their capital levels. Some asset prices declined sharply late last year but have since recovered. Asset prices generally remain at high levels, underpinned by low long-term interest rates. Long-term rates, after earlier rising with the stronger growth, have declined as expectations for the US Federal Reserve's path for monetary policy have been pared back given the weaker growth outlook. Lower interest rates contributed to an easing of pressures in emerging market economies. Despite the weaker outlook, compensation for taking risk remains low in many financial markets.

Domestic economic growth has also eased and the housing market remains weak

Domestic economic conditions remain broadly supportive of financial stability. The unemployment rate has remained around 5 per cent since the previous *Review* and corporate profit growth has also been strong. However, GDP growth in Australia also slowed in the second half of 2018. In particular, consumption growth eased and the outlook for consumption is uncertain.

Conditions in the housing market remain weak. Nationally, housing prices are 7 per cent below their late 2017 peak, although they are still almost 30 per cent higher since the start of 2013. Growth in housing credit was slightly lower over the six months to February than the preceding half year, with investor credit hardly growing at all. Nationally, falling housing prices have been driven by weaker demand and increased housing supply. The tightening in the supply of housing credit from improved lending standards has played a smaller part. Importantly, these more rigorous lending standards have seen the quality of new loans improve in recent years.

Measures of financial stress among households are generally low and households remain well placed to service their debt given low unemployment, low interest rates and improvements to lending standards. However, there has been an increase in housing loan arrears rates. The increase in arrears has been largest in Western Australia, where the decline in mining-related activity has seen housing prices fall for nearly five years and unemployment increase.

Corporate debt remains moderate compared with businesses' income and assets, and businesses are well placed to meet their debt obligations given the strong profit growth. However, commercial property valuations have continued to rise, reflecting ongoing strong investor demand and low interest rates, and rental yields are low, despite low vacancy rates in some locations.

There are risks for Australian financial stability

External

Australia's integration with global trade and financial markets means that external dislocations can be quickly transmitted to domestic economic and financial conditions. Vulnerabilities in key trading partners and global financial markets remain elevated and the likelihood of an event adversely impacting those vulnerabilities has seemingly increased. The weaker global growth outlook includes greater downside risks. Trade tensions could escalate and, in China, the delicate balance being struck between stimulating a slowing economy and addressing financial stability risks could falter. Given global asset prices remain high, there would likely be widespread price falls if either heightened risk aversion or expectations of higher inflation were to see interest rates rise sharply. In some European and emerging market economies, various underlying banking, sovereign debt and structural vulnerabilities remain. These will be exacerbated by slower growth although the easing in global financing conditions and authorities' actions have abated some risks.

High household debt

While housing credit growth in Australia has slowed, household debt is still at a high level. Most households appear to be in a good position to service their debt. Many households have accumulated prepayment buffers, which can compensate for temporary loss of income, although the rate of ongoing excess mortgage payments has slowed. Most households have enough equity in their property such that even much larger price falls than seen to date would still leave the value of their homes greater than their debt. However, high household debt does increase the vulnerability of households and the financial sector to a sharp deterioration in economic conditions. Indebted households could curtail consumption in response to income shocks or uncertainty, which would compound economic weakness and so indirectly affect the financial system.

The slowing housing market

Housing prices have fallen further since the previous *Review*. The falls follow years of strong price growth that had taken prices to high levels. The ongoing large increase in the supply of apartments, particularly in Sydney, will put further downward pressure on prices (see 'Box C: Risks in High-density Apartment Markets'). It is unusual, in Australia and internationally, for property prices to be falling while interest rates and unemployment are low. The prevalence of negative housing equity is low, but substantially larger price falls would see a large share of households' housing equity eroded or even turn negative (see 'Box B: Housing Price Falls and Negative Equity'). This would increase the risk of costly defaults for lenders if unemployment were to rise. Further price falls could also increase lenders' perceptions of the riskiness of housing lending, compounding the somewhat tighter availability of credit seen to date. Greatly reduced credit supply would be detrimental to the economy and so financial stability.

Bank culture and operational risk

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry highlighted deficiencies around culture and governance in the financial system. The final report laid out a path for fairer financial intermediation, which will contribute to a more resilient financial system. But the large degree of change required by some institutions raises the significant challenge of managing the implementation in an effective and timely manner. Further, it raises the risk that the process of addressing these challenges distracts banks from managing other risks.

Australian financial entities face key risks from their large, complex and interconnected information technology systems. These are subject to disruption for a range of reasons, not least of which is cyber attacks. Such attacks are a constant threat to the financial sector and, while a systemic event is unlikely, it could have severe consequences for the financial system.

But the financial system has become more resilient

There have been significant improvements in banks' housing lending standards in recent years. As older loans are repaid and a larger share of banks' loan portfolios has been written under the new tighter lending standards, the average quality of the banks' housing loans will continue to improve. More generally, in the decade since the onset of the financial crisis, significant changes in regulations and in financial institutions' own policies and practices have made them more resilient. Banks now have much higher levels of capital, more liquid assets and more stable funding structures. Stress tests of the banks indicate that they have sufficient capital to withstand double-digit unemployment rates and housing price falls exceeding 30 per cent. These tests are simulated exercises, but the banks have also experienced an actual, although smaller, stress event in Western Australia, where housing prices have fallen almost 20 per cent and the unemployment rate has risen 3 percentage points. Housing loan arrears rates in Western Australia have been increasing but are currently still less than 2 per cent. Overall, the financial system appears much better placed to respond to a range of challenges than it was a decade ago.