3. Domestic Financial Conditions

Australian financial conditions have tightened further in recent months as the Reserve Bank has continued to increase the cash rate.

Yields on Australian Government Securities (AGS) have continued to be volatile in recent months, mirroring large moves in global bond yields. Yields rose sharply over August and September as persistently high inflation increased expectations for further rapid monetary policy tightening by most central banks; fiscal developments in the United Kingdom also contributed to the increase in volatility. Overall, AGS yields are now back to around their June peaks. Money market rates have continued to rise, with market participants expecting further policy tightening in the near term. Current market pricing implies expectations of an increase in the cash rate to a little over 3 per cent by the end of 2022 and around 4 per cent by mid-2023. Bond markets have continued to function reasonably well, with some minor deterioration in late September during heightened volatility arising from developments in the United Kingdom.

Banks' funding costs have increased alongside the rise in market yields and increases in the cash rate. Up to October, lenders have passed on the cash rate increases in full to reference rates for variable-rate housing and business borrowers. When this *Statement* was finalised, the largest housing lenders had announced they will likewise pass on the November increase in full. Scheduled payments on housing loans have increased and, given the normal lags, will continue to do so over the coming months. Commitments for new housing loans have declined considerably, consistent with higher interest rates, falling housing prices and lower turnover in the housing market. Though housing credit growth has declined, business credit has grown strongly, particularly borrowing by medium- and large-sized firms.

The Australian dollar has depreciated over recent months and volatility has increased in foreign exchange markets. These developments have occurred alongside the decline in yields on Australian Government bonds relative to those of the major advanced economies, a further broad-based appreciation of the US dollar, and declines in the prices of international risk assets and several commodities amid concerns about the global growth outlook.

AGS yields have been volatile

Yields on AGS have been volatile, with both three- and 10-year bonds trading in a 100 basis point range since the previous *Statement* (Graph 3.1). Yields have risen considerably since August, to be back around their peaks in June. AGS yields declined for a time in response to the Board's October announcement to raise the cash rate by less than the market expected. Yields also declined a little in response to the Board's November announcement to increase the cash rate by 25 basis points.

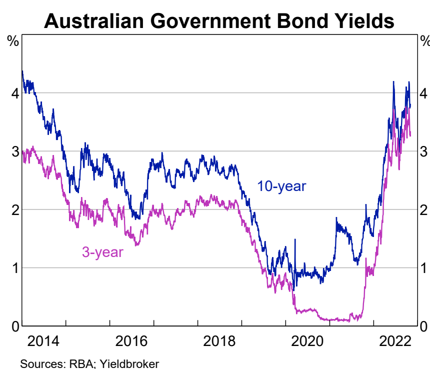
Movements in long-term AGS yields over the past three months have generally followed moves in yields in international markets (Graph 3.2). Yields rose in response to high and persistent inflation in advanced economies, which led to expectations that central banks

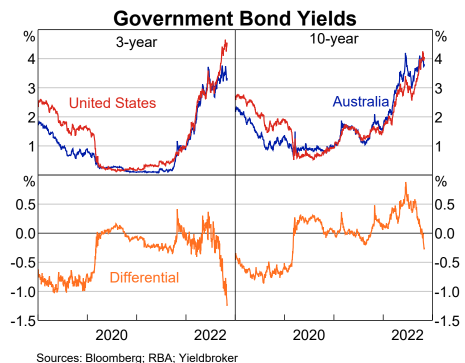
would need to increase policy rates faster and to a higher level than expected at the time of the previous *Statement*. Also contributing was a sharp rise in UK Government bond yields in response to the government's 'mini budget', which raised market expectations for substantial additional UK bond issuance and higher policy rates. There was a temporary retracement in AGS yields in response to subsequent bond purchases by the Bank of England that helped to address dysfunction in UK bond markets, and to following developments in UK fiscal policy. The Reserve Bank's decision to increase the cash rate by 25 basis points at the October meeting also contributed to lower AGS yields for a time, as many market participants had expected an increase of 50 basis points and so re-evaluated the expected path of the cash rate. AGS yields also fell a little in response to the Reserve Bank's decision at the November meeting to increase the cash rate by 25 basis points, which was viewed as reducing the likelihood of larger increases in future. Nonetheless, AGS yields remain much higher than at the previous *Statement*, and are around their recent peaks in June.

The differential between yields on 10-year AGS and US Treasuries has declined considerably to be around –25 basis points, from around 90 basis points in June (which had been its highest level since 2014). The decline in the differential has been more pronounced in shorter term yields, with the differential between three-year AGS and US Treasuries around –120 basis points. This reflects market participants' expectation that US interest rates will be higher for longer than Australian interest rates, given the outlook for higher inflation and wages growth in the United States.

The increase in longer term AGS yields has been largely driven by higher real yields as evidenced by similar moves in inflation-linked bond markets, and reflects expectations for further increases in policy rates. Market measures of longer term inflation expectations (which capture both inflation expectations and risk premia) remain stable and well anchored, suggesting that the anticipated monetary tightening is expected to be sufficient to keep inflation around the target range over the medium term. Shorter term AGS yields have also increased, reflecting higher real yields, while inflation compensation at shorter tenors has declined (Graph 3.3).

Yields on semi-government securities (semis) have increased further than AGS yields, reflecting an increase in risk premia and a considerable widening in swap spreads during a period of rising volatility in bond markets globally.





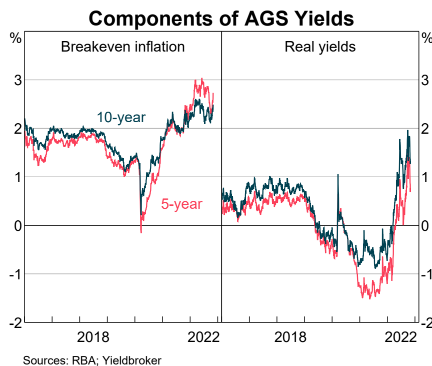
Government bond issuance continues to be slower than last year

Bond issuance by the Australian Office of Financial Management (AOFM) continues to be a little slower than 2021, reflecting improvement in the Australian Government's underlying fiscal position (Graph 3.4). Consistent with this, the AOFM announced guidance for its 2022/23 fiscal year issuance of around $95 billion – a decrease of around $30 billion on previous guidance.

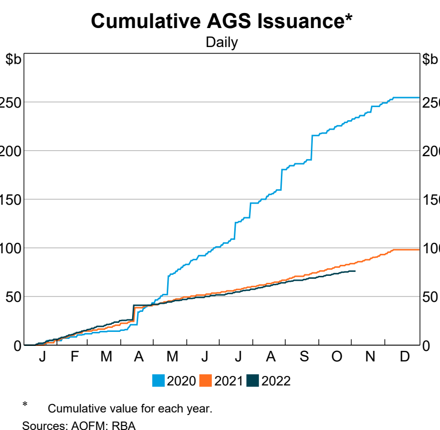
Most measures suggest bond markets have functioned reasonably well

Market contacts reported that liquidity decreased a little around the period of heightened volatility in UK bond markets in late September and early October. Nonetheless, bid-offer spreads for longer term AGS and semis remain around their lowest levels in recent years, despite increased volatility in yields in recent months (Graph 3.5). By contrast, market liaison suggests that there are some strains in the swap market, with flows particularly one-sided and the spread between swap rates and AGS yields has been at its highest level in a decade.

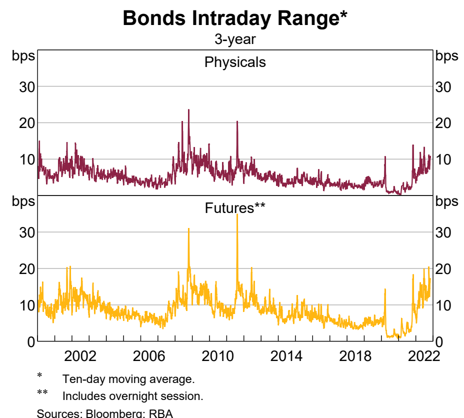
Demand to borrow AGS from the Bank has remained high but stable in recent months (Graph 3.6). Market participants borrowed an average of a little under $6 billion of bonds per day from the Bank over this period. Demand remains focused on bonds with residual maturities of two to three years, particularly those where the stock available in private markets is more limited because of the Bank's earlier purchases. Bond dealers borrow these bonds to help settle their own transactions and the transactions of their clients. By lending these bonds back into the market for short periods, the Bank is supporting the functioning of government bond markets.



Sources: RBA; Yieldbroker



* Cumulative value for each year.
Sources: AOFM; RBA



* Ten-day moving average.
** Includes overnight session.
Sources: Bloomberg; RBA

Cash rate expectations are little changed for the near term but have increased for later in 2023

Market expectations for the level of the cash rate through to early 2023 have been little changed in recent months. Expectations initially increased through August and September, alongside expectations for higher inflation globally in the near term and consequently policy rate rises in advanced economies, including Australia. However, this upward move was retraced following the Board's lower-than-expected increase in the cash rate in October. Following the increase in the cash rate target to 2.85 per cent in early November, prices for overnight indexed swap (OIS) contracts imply that market participants expect the cash rate to be increased in December to finish the year around 3.1 per cent, similar to most market economists' cash rate expectations. Market expectations for the cash rate through mid-to-late 2023 have increased over the past three months, to reach a peak of around 4 per cent (Graph 3.7).

In recent months, transaction volumes in the cash market have picked up. As a result, the cash rate was determined by market transactions on most days. The cash rate has increased in line with the cash rate target since August, remaining 4 basis points below the target.

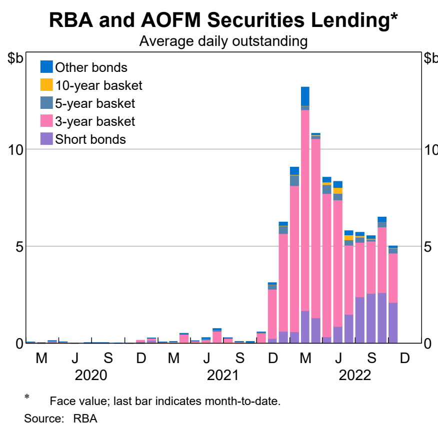
Money market rates have continued to rise

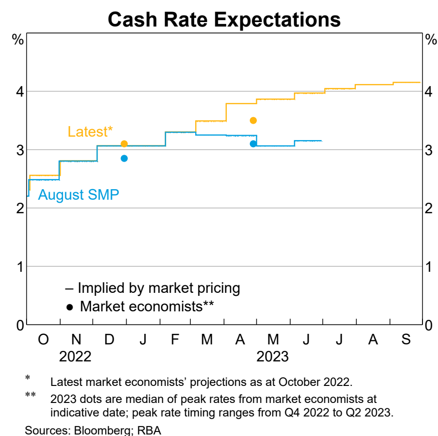
Short-term money market rates have increased over recent months, including bank bill swap rates (BBSW), consistent with the increase in the cash rate and market expectations for further increases (Graph 3.8). The cost of Australian dollar funding from offshore short-term issuance (via the foreign exchange swap market) also moved higher over the past three months.

Repurchase agreement (repo) rates at the Bank's regular open market liquidity operations (OMO) have also increased, with the OMO hurdle rate continuing to be set at term-matched OIS plus a modest spread. Demand for short-term liquidity obtained at OMO has increased a little in recent months, but remains low relative to pre-pandemic activity, reflecting large Exchange Settlement balances.

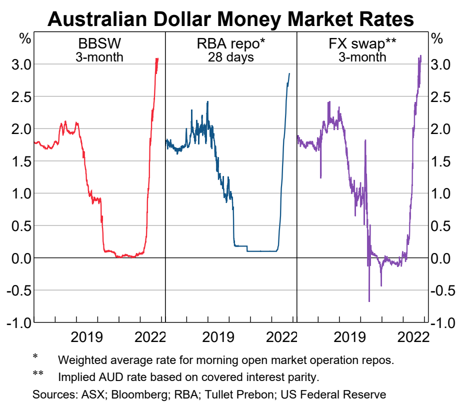
The Bank's balance sheet remains large but will decline over the next few years

The Bank's balance sheet has been little changed at around $620 billion over the past few months (Graph 3.9; Graph 3.10). This follows





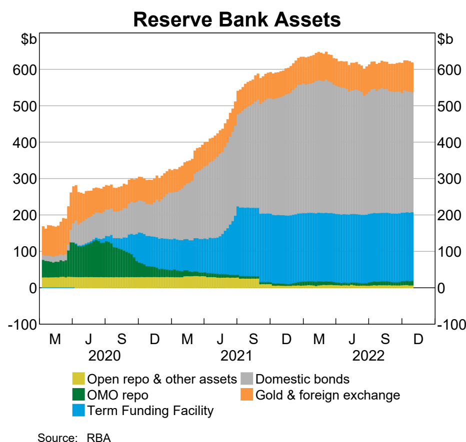
a large expansion in 2020 and 2021, reflecting the policy measures introduced by the Bank in response to the COVID-19 pandemic. Since the previous *Statement*, the composition of assets has changed, with higher bond yields leading to a decline in the market value of the Bank's bond holdings, while a depreciation in the exchange rate increased the Australian dollar value of gold and foreign exchange. The Bank's balance sheet will decline over the coming years as Term Funding Facility (TFF) funding matures between early-to-mid 2023 and mid-2024. Also, the maturity of the Bank's government bond holdings will contribute to a decline in the Bank's balance sheet over a number of years.

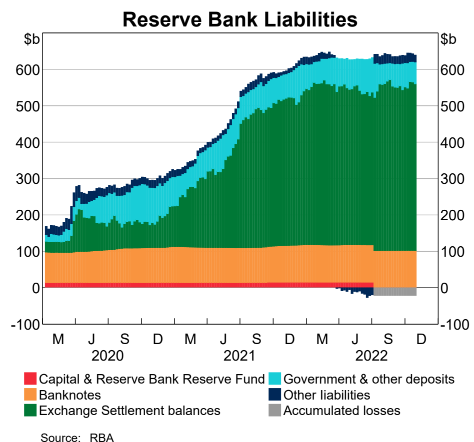


Bank bond issuance slowed in recent months

Bank bond issuance has slowed in recent months but remains high over the year to date, following strong issuance earlier in the year (Graph 3.11). Banks raised $27 billion in bond markets during the three months to the end of October, with an average tenor of around five years – a little lower than the average of recent years. Covered bond issuance remained relatively high at $5.5 billion over this time. Year-to-date issuance of covered bonds is at the second highest level since their introduction in 2011. Some of this recent issuance may have reflected a preference for secured products, which can be easier to issue during times of financial market volatility.

Bank bond yields remain around their levels of three months ago, after increasing sharply in the earlier part of the year. Yields on three-year bonds are currently around 5 per cent – the highest level since 2012 (Graph 3.12). Movements in recent months have been broadly in line with those in the swap rate (a reference rate for the pricing of fixed-income securities), with the spread to the swap rate little changed in net terms over the past three months.



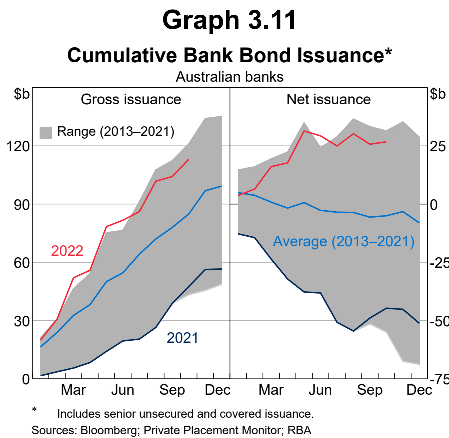


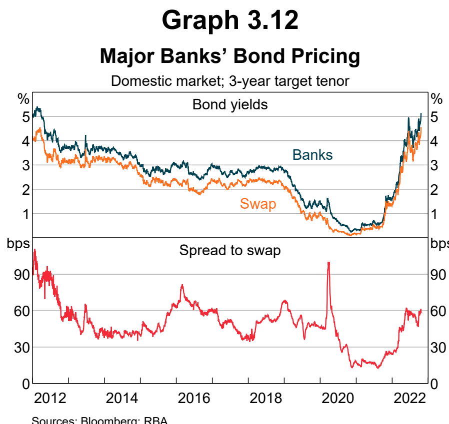
Issuance of RMBS by non-banks has increased and spreads have widened

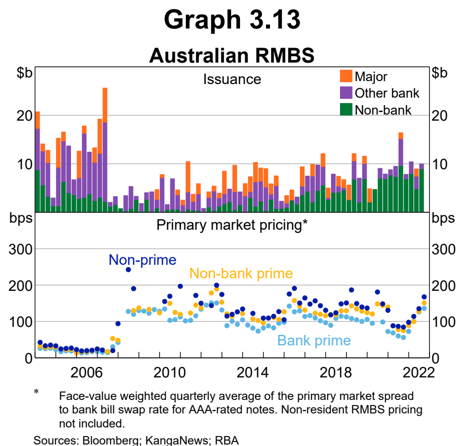
Issuance of residential mortgage backed securities (RMBS) have remained robust in recent months. Non-banks, which have increased issuance in recent months, accounted for $9 billion of the $10 billion issued in the September quarter – the highest share since the June quarter of 2020; they then accounted for all the issuance in October (Graph 3.13). Spreads on RMBS widened further. Market liaison with banks confirmed that wider spreads in RMBS markets made issuance less appealing for them compared with senior unsecured and covered bond issuance.

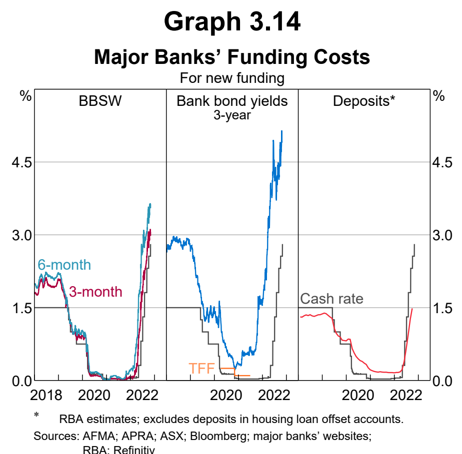
Banks' funding costs have increased considerably

Banks' overall funding costs have continued to increase in recent months, and are now higher than they were before the pandemic. These increases have been underpinned by rising BBSW rates, reflecting actual and prospective increases in the cash rate (Graph 3.14). Much of banks' wholesale debt and deposit costs are linked to BBSW rates directly or through hedging. For example, banks can use interest-rate swaps to hedge a portion of their fixed-rate liabilities to better match the floating rates earned on a large share of their assets. The cost of these hedges is closely linked to BBSW rates.





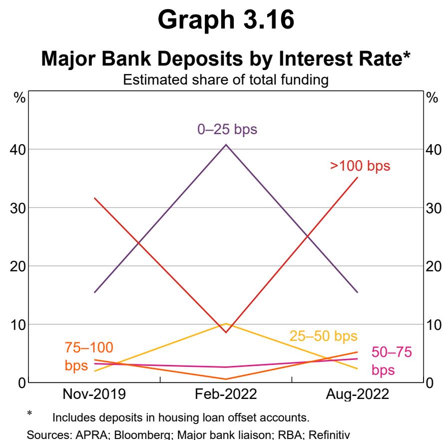


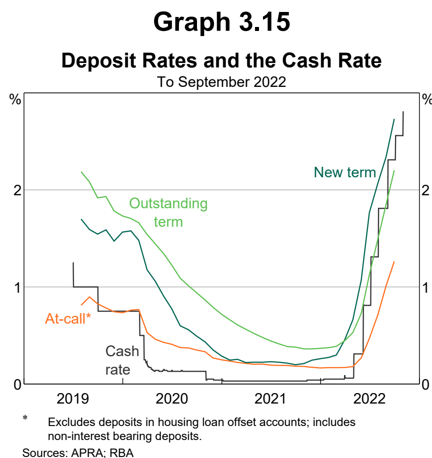


Average deposit rates have risen, but by less than the cash rate

Average rates paid on at-call and new term deposits have increased over recent months (Graph 3.15). These increases are contributing to higher funding costs, as deposits make up around 60 per cent of banks' funding. The average rate on at-call deposits – which account for the bulk of deposits – has increased by less than the cash rate. By contrast, average rates on new term deposits have increased by more than the cash rate, in line with larger movements in BBSW and longer term swap rates, which are the key benchmarks used to price these products. In line with higher average deposit rates, since February the share of major banks' deposits paying low interest rates (between 0 and 25 basis points) has fallen to around 15 per cent; a similar share to before the pandemic (Graph 3.16). These low-rate deposits include some at-call savings accounts offered to retail customers, which only pay a 'bonus' rate of interest when certain conditions are met; otherwise, the rate is typically less than 50 basis points. Interest rates on transaction accounts have also generally remained low (or in some cases at zero per cent).

The stock of deposits has continued to grow over recent months, underpinned by increases in the volume of term deposits (Graph 3.17). Term deposits have become more attractive of late as, on average, the rates on new term deposits have increased more quickly than the rates paid on at-call deposits. This increasing spread partly reflects that some banks have sought to attract funds into term deposits through higher rates due to their more favourable treatment for banks' liquidity ratios than at-call deposits. In addition, depositors tend to demand a higher rate in return for locking away funds for a period of time. This spread was compressed during the pandemic as interest rates fell close to zero.





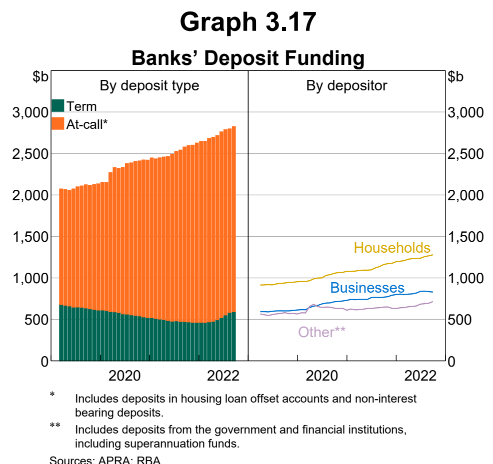


Table 3.1: Growth in Financial Aggregates

Percentage change[(a)]

	Three-month annualised		Six-month annualised	
	Jun 22	Sep 22	Mar 22	Sep 22
Total credit	11.0	9.4	8.7	10.2
– Household	7.0	5.8	7.3	6.4
– Housing	7.5	5.9	8.0	6.7
– Owner-occupier	7.6	6.5	8.6	7.1
– Investor	7.3	4.9	6.7	6.1
– Personal	0.4	2.2	–1.0	1.3
– Business	19.7	16.4	11.4	18.1
Broad money	9.7	2.5	9.0	6.0

(a) Seasonally adjusted and break-adjusted.

Sources: ABS; APRA; RBA

Growth in total credit remained strong

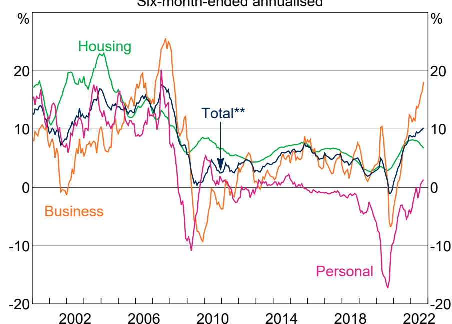
Total credit growth on a six-month-ended annualised basis has increased further in recent months, and remains at around its fastest pace in more than a decade (Graph 3.18; Table 3.1). The increase in total credit growth has reflected strong growth in business credit. By contrast, growth in housing credit has declined. Personal credit, which accounts for only 4 per cent of total credit, grew slightly over the September quarter, after consistently falling since 2015 (in part because consumers shifted to using debit cards rather than credit cards). This growth in personal credit has largely reflected increases in outstanding credit card balances, consistent with strong nominal consumption growth, and follows a sharp decline in credit card spending during the pandemic.

Demand for new housing loans has declined sharply but refinancing activity has reached new highs

Housing credit growth declined in September to 6¾ per cent on a six-month-ended annualised basis (Graph 3.19). Both owner-occupier and investor credit growth have declined in recent months. Housing credit growth is expected to decline further, as commitments for new housing loans have continued to fall. Commitments are now 25 per cent below their peak in January 2022. The large decline in housing commitments in recent months follows further increases in interest rates and noticeable declines in housing prices and turnover (Graph 3.20).

By contrast, commitments for external refinancing (switching to a new housing lender) have reached record high levels. Borrowers with variable-rate loans are searching for a better deal on their mortgage as interest rates and the cost of living increase. At the same time, a higher

Graph 3.18



* Seasonally adjusted and break-adjusted; including securitisation.
** Includes housing, personal and business credit.
Sources: ABS; APRA; RBA

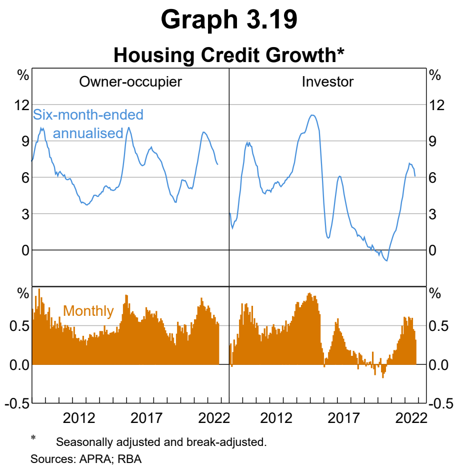
number of borrowers who took out fixed-rate loans during the pandemic have reached the end of their fixed-rate period and are shopping around for a new loan. These data do not capture borrowers negotiating a lower rate with their current lender, which has also increased.

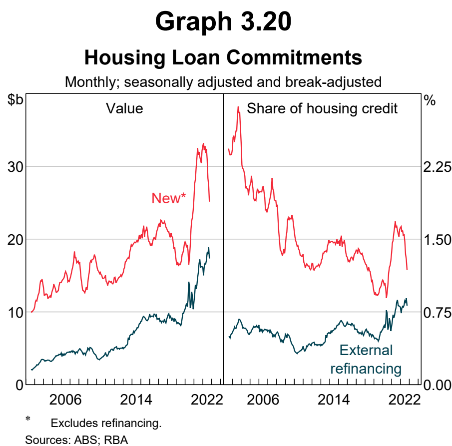
Interest rates on housing loans have risen further

Housing lenders have passed on the cash rate increases up to October in full to their reference rates for variable-rate loans (Graph 3.21). At the time this *Statement* was finalised, the largest housing lenders had announced they would pass through the November increase in the cash rate in full to their housing reference rates. Most borrowers pay a lot less than the reference rate, as lenders offer discounts.[1]

Data to the end of September (the latest available data) show that the average variable rate on outstanding housing loans is around the level of early 2014. Although standard reference rates have so far moved in line with the cash rate this year, the average outstanding rate has risen by a little less than the cumulative increase in the cash rate (Table 3.2). This mostly reflects existing borrowers refinancing or renegotiating the terms of their existing loan to take advantage of the larger discounts available for new variable-rate loans. Interest rates on new variable-rate loans remain around 50 basis points lower than on outstanding loans.

Fixed rates on new loans have increased rapidly over the past year alongside the rise in swap rates (the pricing benchmark for these loans). Given new fixed rates are on average higher than new variable rates, the share of new lending at fixed rates has declined to be well below pre-pandemic levels. By contrast, the average rate paid on outstanding fixed-rate loans has edged up only a little in recent months, as existing fixed-rate loans gradually expire and relatively few borrowers take out new fixed-rate loans (Graph 3.22).





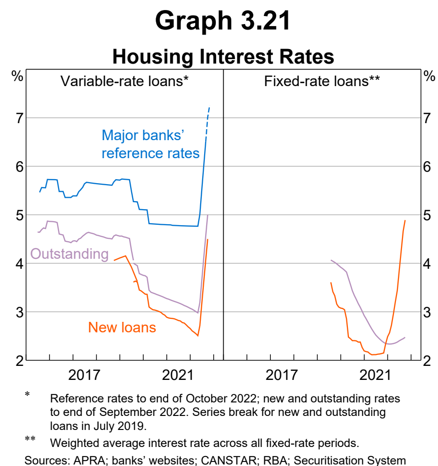


Table 3.2: Average Outstanding Housing Rates

September 2022

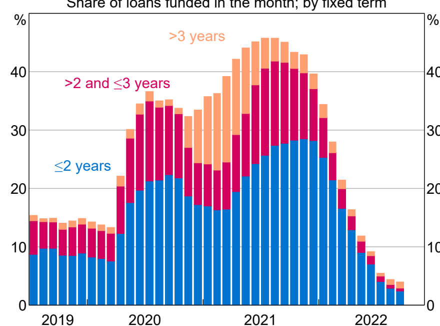
	Interest rate in Sep 2022 Per cent	Change since Apr 2022 Basis points	Change since Feb 2020 Basis points
Cash rate	2.35	225	160
Variable-rate loans			
– Owner-occupier	4.88	202	131
– Investor	5.25	204	128
– All variable-rate loans	5.00	202	129
Fixed-rate loans			
– Owner-occupier	2.36	13	–136
– Investor	2.69	9	–132
– All fixed-rate loans	2.47	12	–138
Loans by repayment type(a)			
– Principal-and-interest	4.07	140	45
– Interest-only	4.74	150	51

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

Sources: APRA; RBA

Housing loan payments will increase further over coming months

Total scheduled payments on housing loans increased slightly in the September quarter, as increases in the cash rate were passed through to variable-rate borrowers (Graph 3.23). Borrowers who took out fixed-rate loans during the pandemic at low interest rates are facing higher loan payments as their fixed-rate period expires and they roll off onto a new, higher interest rate. Recent increases in the cash rate will result in loan payments increasing further over the coming months, as it typically takes one to two months for a cash rate increase to fully flow through to payments on variable-rate housing loans. Total scheduled payments on housing loans are projected to increase to around 9¼ per cent of household disposable income by the end of 2023, based on cash rate increases to date and maturing fixed-rate loans rolling into higher interest rate loans.[2]



Net payments into offset and redraw accounts over the year to date are slightly below those in 2021. Net payments slowed in the September quarter, though in aggregate households continued to accumulate funds in these accounts. Since early 2020, mortgage borrowers have paid $113 billion into offset and redraw accounts – about 7 per cent of household disposable income.

As at September, owner-occupiers with variable-rate loans had a median buffer of around 1⅔ years of scheduled payments. However, as discussed in the October *Financial Stability*

Review, these buffers are unevenly distributed. A small group of variable-rate borrowers with low incomes, small liquidity buffers and high debt are most vulnerable to payment difficulties (and therefore needing to reduce their consumption) – including those with relatively new loans and less housing equity.

Interest rates on business loans have also risen

Interest rates on variable-rate business loans have increased over recent months in line with the cash rate and three-month BBSW (which is the benchmark for most loans to medium- and large-sized businesses) (Graph 3.24). All of the major banks and a number of smaller banks have passed on the cash rate increases up to September in full to their published small business indicator rates. Outstanding interest rates on fixed-rate loans have also risen as higher rates gradually flow through to the stock of fixed-rate loans.

Growth in business debt has been very strong

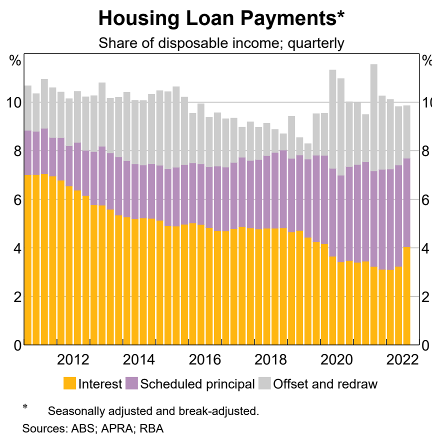
Growth in business debt remains well above the average of recent years. This has reflected strong growth in business credit, which on a six-month-ended annualised basis has increased to its fastest pace in more than a decade (Graph 3.25).

Lending to the property services and finance industries has contributed about half of the growth in business credit over the past year. Lenders have financed a large pipeline of commercial property transactions, predominantly for existing properties. More broadly, strong economic conditions and the lags associated with financing elevated merger and acquisition (M&A) activity over the past year have contributed to growth in business credit. Businesses have also drawn down on their existing credit facilities in order to manage liquidity challenges arising from supply chain disruptions.

Graph 3.23

Housing Loan Payments*

Share of disposable income; quarterly

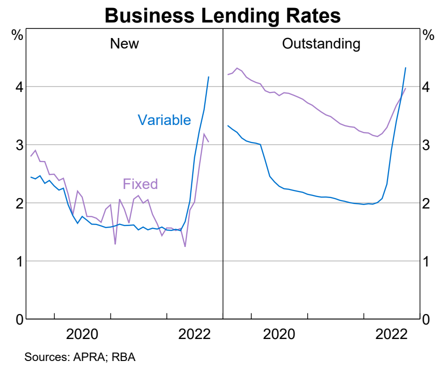


* Seasonally adjusted and break-adjusted.

Sources: ABS; APRA; RBA

Graph 3.24

Business Lending Rates

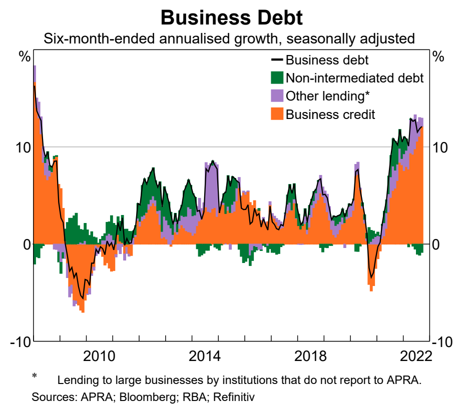


Sources: APRA; RBA

Graph 3.25

Business Debt

Six-month-ended annualised growth, seasonally adjusted



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

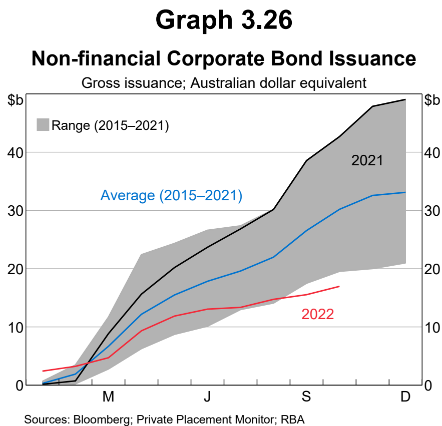
Sources: APRA; Bloomberg; RBA; Refinitiv

By contrast, non-financial corporate bond issuance over the year to date is well below the average of recent years (Graph 3.26). In the three months to the end of October, 16 non-financial corporate bonds were issued, totalling $3.6 billion, most of which were in offshore markets. This pace of issuance is in line with activity since around May, and so does not appear to reflect issuers' reluctance to issue in the face of recent global bond market volatility.

Australian equity prices are back to their mid-August peak

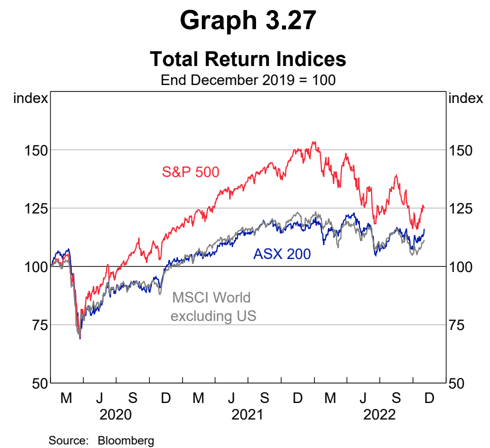
The ASX 200 index has experienced a recent rally to take it back to around its mid-August peak on a total-return basis, outperforming US and other advanced economy markets over recent months (Graph 3.27). Australian equity prices had fallen in September, reflecting investor concerns that global interest rates might increase by more than previously expected, as well as concerns around global growth and the outlook for corporate profits.

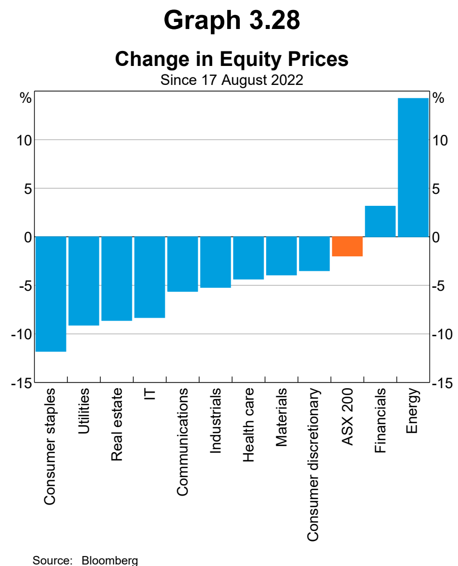
Since the mid-August peak, the energy sector posted the largest increase in equity prices, as oil prices rebounded from late September (Graph 3.28). After performing strongly earlier in the year, stocks in the materials sector have declined in recent months, in line with the price of iron ore. The real estate sector has also fallen in recent months, reflecting concerns about the sensitivity of the sector to interest rate rises.



Merger and acquisition activity has decreased

Announced M&A deals have declined from the high level of activity in 2021 (Graph 3.29). While it is uncertain what share of these deals will be completed, the total value of deals over the year to date at around $153 billion is slightly above pre-pandemic levels.





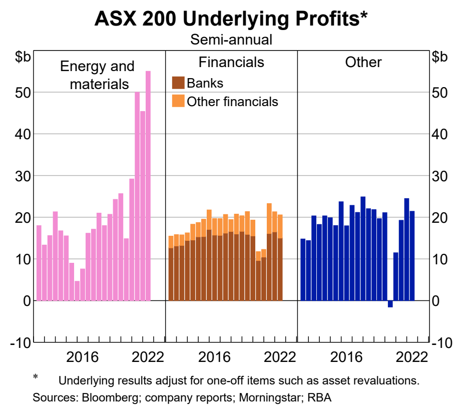
Profits and dividends of Australian companies remained around record highs

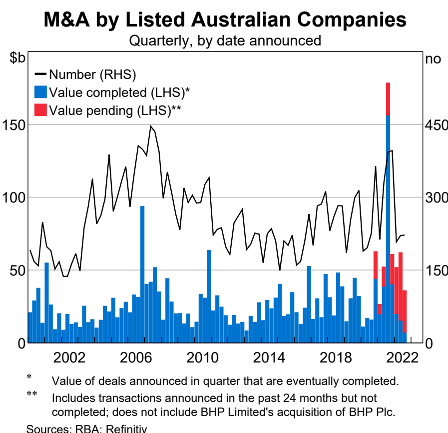
Underlying profits of ASX 200 companies increased in the first half of 2022 relative to the same period a year earlier (Graph 3.30). Around two-thirds of ASX 200 companies reported earnings growth, despite higher cost pressures being commonly cited as a challenge. The energy and materials sectors reported record profits due to elevated commodity prices. Overall, earnings were slightly better than analysts' expectations. Nevertheless, due to uncertainty about the macroeconomic outlook, many ASX 200 companies have downgraded or removed earnings guidance for the upcoming financial year.

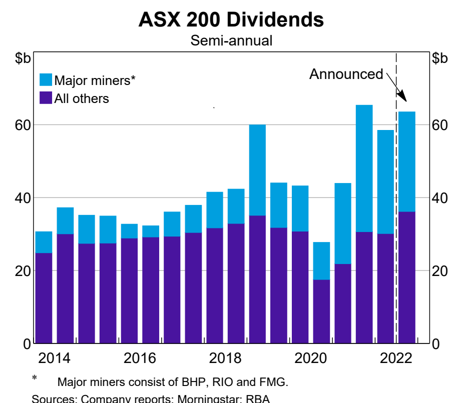
Dividends announced in the second half of 2022 rose in comparison to the first half of the year, but were slightly lower than the same period a year earlier (Graph 3.31). The three major miners again represented a large share of total dividends, with $27 billion announced. Outside these companies, dividends increased to be slightly above their pre-pandemic high.

The Australian dollar has depreciated

The Australian dollar has depreciated by about 2 per cent on a trade-weighted (TWI) basis since early August, and is around 8 per cent lower against the US dollar over the same period. This is consistent with the decline in yield differentials between Australian Government bonds and those of the major advanced economies. The currency depreciated to a year-to-date low of around US$0.62 in mid-October, alongside broad US dollar strength and declines in international risk asset prices amid concerns about the outlook for global growth (see chapter on 'The International Environment'). It has since retraced some of this move to be slightly below US$0.64. The RBA Index of Commodity Prices (ICP) has declined over recent months to be around levels seen earlier this year, with higher coal prices partly offsetting declines

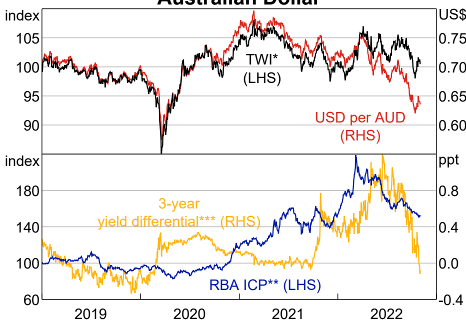


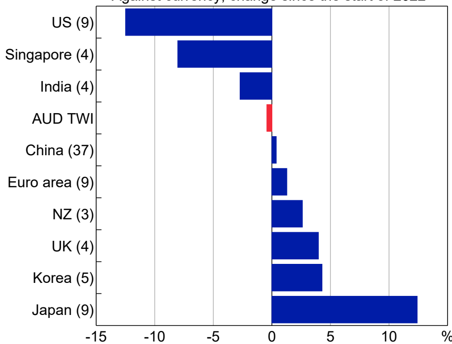




in the prices of iron ore and base metals (Graph 3.32). Consistent with developments in international financial markets, measures of volatility have increased for the Australian dollar.

Despite having depreciated by around 12 per cent against the US dollar over the year to date, the Australian dollar is around its levels at the beginning of 2022 on a TWI basis. The difference largely reflects the appreciation against the Japanese yen earlier in the year, although the Australian dollar also remains higher against several other currencies, including the South Korean won, the British pound and the New Zealand dollar (Graph 3.33).

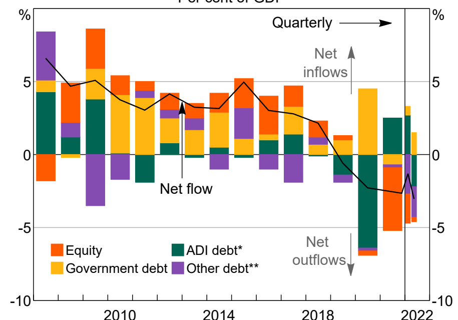




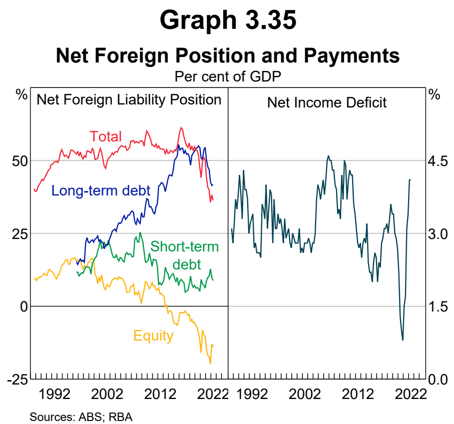
Australia's financial account deficit widened in the June quarter

Australia has continued to be a net exporter of capital with the financial account deficit widening in the June quarter; this is consistent with the widening of the current account surplus and the record trade surplus. The net outflow of capital was associated with issuance of loans by Australian banks to non-residents and a withdrawal of foreign deposits from both the Australian banking sector and the Reserve Bank, which in part reflected higher interest rates overseas relative to those in Australia (Graph 3.34).

Australia's net foreign liability position as a share of GDP decreased slightly over the June quarter, and remains around its lowest level since the 1980s (Graph 3.35). The net foreign liability position is around 36 per cent of GDP, having peaked at about 60 per cent in 2016. Underlying this decline is the increase in Australia's net foreign equity asset position. This has been driven by valuation effects associated with foreign equities outperforming Australian equities over several years, as well as the accumulation of foreign equity assets, including by Australia's superannuation funds that have increased the share of foreign equities in their portfolios.[3] The net income deficit – the net



payments made to service the net foreign liability position – was little changed over the quarter, but has increased over the year, reflecting higher commodity prices flowing through to an increase in dividend payments and direct investment income payments to non-residents. ✠



Endnotes

[1] See RBA (2019), 'Box D: The Distribution of Variable Housing Interest Rates', *Statement on Monetary Policy*, November. Available at <https://www.rba.gov.au/publications/smp/2019/nov/box-d-the-distribution-of-variable-housing-interest-rates.html>

[2] See RBA (2022), 'Household and Business Finances in Australia', *Financial Stability Review*, October. Available at <https://www.rba.gov.au/publications/fsr/2022/oct/household-business-finances-in-australia.html>

[3] For more information on the significant shift in Australia's balance of payments over recent years, see Adams N and T Atkin (2022), 'The Significant Shift in Australia's Balance of Payments', RBA *Bulletin*, March. Available at <https://www.rba.gov.au/publications/bulletin/2022/mar/the-significant-shift-in-australias-balance-of-payments.html>