2. International Financial Conditions

Global financial markets have stabilised in recent months and financial conditions are supporting economic growth. Central banks continue to maintain highly accommodative policy settings, and in some cases have eased monetary policies a little further. Governments have taken policy action to address the COVID-19 pandemic and its effects on economic activity, and have thus needed to fund very large fiscal deficits. Accordingly, government bond issuance has increased substantially. Government bond markets are nonetheless functioning well and yields have stabilised at historically low levels, supported by bond purchases by central banks and expectations that policy rates will remain low for an extended period.

Corporate borrowing costs have declined to around pre-COVID-19 levels, and non-financial corporations have issued record amounts of corporate debt. Corporate financing conditions have been supported by the introduction of central bank programs to support the flow of funding to businesses (see Box C: Central Bank Policy Responses to COVID-19). As expected, corporate earnings have fallen sharply in response to the downturn in economic activity brought on by COVID-19. At the same time, equity prices have risen, indicating that the market expects the decline in earnings to be short-lived. The US dollar has depreciated since late May and is around levels observed prior to the pandemic against the currencies of other advanced economies. In line with this, the Australian dollar has appreciated further since the previous *Statement* and is now a bit above pre-pandemic levels, having depreciated sharply earlier in the year.

Central banks' policy settings are accommodative in advanced economies

Central banks in advanced economies have maintained accommodative policy settings or eased policies further. Policy rates remain near zero or lower, with central banks signalling that rates are likely to remain at very low levels until there is sustained evidence of progress towards employment and inflation goals. Consistent with this guidance and central banks' economic forecasts, market pricing implies that policy rates are expected to stay at present or lower levels for some time (Graph 2.1). Some central banks, including the US Federal Reserve (Fed) and the Bank of Canada (BoC), have indicated that any further reductions in interest rates (to be below zero) may have adverse side effects on financial markets. In contrast, the Bank of England (BoE) and the Reserve Bank of New Zealand (RBNZ) have highlighted that they are considering the possibility of lowering their policy rates below zero.

Central banks continued to purchase large volumes of government bonds, although their focus has shifted to the objective of easing financial conditions rather than alleviating market dysfunction (Table 2.1). The Fed has slowed the pace of Treasury purchases since April in response to signs of improved market functioning, and has now increased its holdings by around US$1.8 trillion since the onset of COVID-19. The European Central Bank (ECB)

Table 2.1: Central Bank Net Purchases of Government Bonds

Programs announced since 3 March

Central bank	End date	Purchase target	Purchases to date		
			Nominal	Per cent of GDP	Per cent of target
Fed	Open-ended	Unlimited	$1.8tn	8	n/a
ECB	June 2021	€1,176bn[(a)] [(b)]	€509bn[(b)]	4	43
BoJ	Open-ended	Unlimited (yield curve control)	¥34.3tn	6	n/a
BoE	End 2020	£290bn	£202.6bn	9	70
BoC	Open-ended	Unlimited	C$235.8bn	10	n/a
RBNZ	Open-ended	NZ $60bn[(b)]	NZ$23.6bn[(b)]	7	39
Riksbank	June 2021	SEK 500bn[(c)]	SEK15.5bn	0.3	3
RBA	Open-ended	Unlimited (yield curve target)	A$51.8bn[(b)]	3	n/a

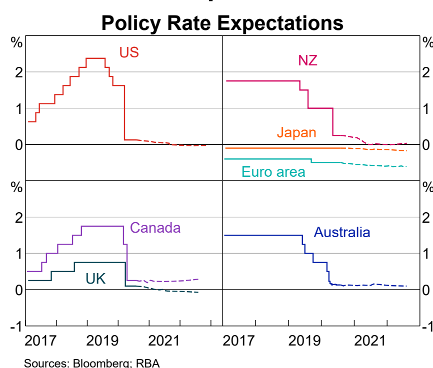
(a) The total size of the PEPP (€1,350bn) includes government bonds and private sector assets. The estimated purchase target for government bonds is based on the current composition of asset holdings.

(b) Includes local and semi-government bonds.

(c) Includes purchases of private sector assets.

increased the size of its Pandemic Emergency Purchase Program (PEPP) by €600 billion to €1,350 billion, and extended the term of the program by six months to the end of June 2021. The ECB has also slowed the pace of its asset purchases since early July following a stabilisation in financial market conditions. The BoE has announced that it will conduct an additional £100 billion worth of government bond purchases by the end of the year, albeit at a slower pace than before. The RBNZ increased the size of its Large Scale Asset Purchase program from NZ$33 billion to NZ$60 billion, and announced that it will begin purchasing inflation-indexed bonds in addition to its ongoing purchases of central and local government bonds.

Graph 2.1



Sources: Bloomberg; RBA

Measures aimed at restoring market functioning have been scaled back

Conditions in short-term funding and sovereign bond markets have improved and central banks have responded by scaling back some measures aimed at addressing impaired market functioning. The Fed modified the timing of its overnight repurchase (repo) operations to occur after the peak period of daily repo market transactions and increased the minimum interest rate, signalling that it intends to shift to a backstop role in the repo market. As a result, there has been no participation at the Fed's recent repo operations (Graph 2.2). The Fed also announced that it will no longer conduct three-month repo operations. The BoC and the BoE have similarly reduced the frequency of some repo operations in response to a decline in the use of these facilities.

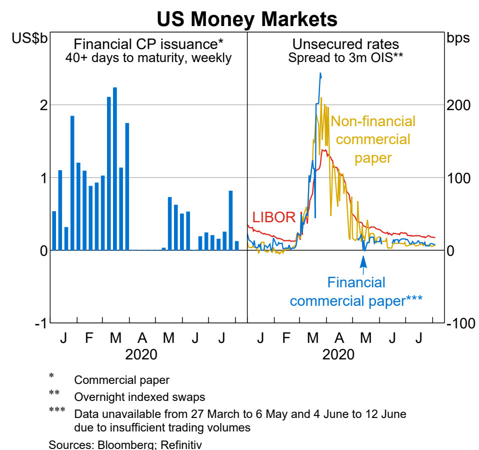
Conditions in short-term US dollar funding markets have improved significantly

US dollar funding conditions have eased as liquidity has improved and risk appetites have recovered. Inflows to prime money market funds (which invest in riskier money market assets) have recovered strongly, which has encouraged these funds to resume investing at terms longer than a few days. In turn, financial firms have been able to resume their issuance of longer-term commercial paper and the interest rates on commercial paper have declined (Graph 2.3). Reflecting these developments, Fed purchases of assets sold by money market funds have declined and there has been limited take-up of a backstop facility for firms unable to roll over their issuance of commercial paper.

The cost of borrowing US dollars in foreign exchange swap markets has declined, having increased sharply in March. As conditions have eased, banks have begun to repay the US dollars they had obtained under the Fed's swap lines with other central banks, and the total amount outstanding for these facilities has declined from around US$450 billion to around US$100 billion (Graph 2.4). Notwithstanding these improvements, the Fed has extended the duration of its US dollar swap lines with nine central banks, including the Reserve Bank. The Fed noted that these extensions were not related to specific concerns but would help to sustain recent improvements in global US dollar funding markets. In Australia, there has been very little take-up of the swap line via the Reserve Bank's US dollar operations as banks have been able to obtain US dollars from financial markets on more favourable terms. There have been no bids at auctions for US dollars via the swap line since the previous *Statement* and the Reserve Bank has paused its schedule of auctions for now.

Graph 2.3

US Money Markets

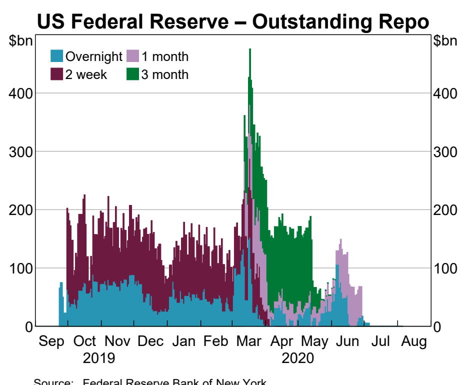


* Commercial paper
** Overnight indexed swaps
*** Data unavailable from 27 March to 6 May and 4 June to 12 June due to insufficient trading volumes

Sources: Bloomberg; Refinitiv

Graph 2.2

US Federal Reserve – Outstanding Repo

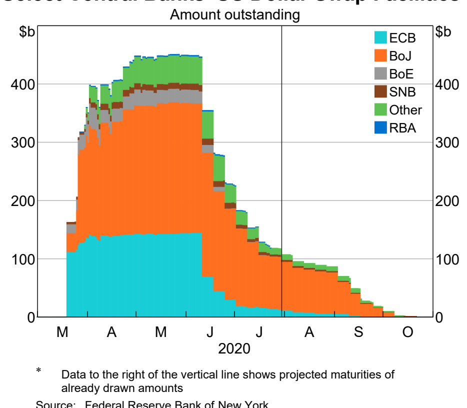


Source: Federal Reserve Bank of New York

Graph 2.4

Select Central Banks' US Dollar Swap Facilities*

Amount outstanding



* Data to the right of the vertical line shows projected maturities of already drawn amounts

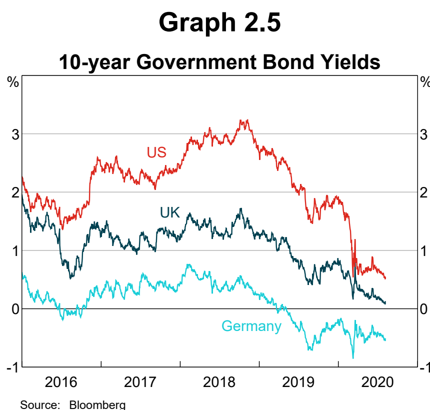
Source: Federal Reserve Bank of New York

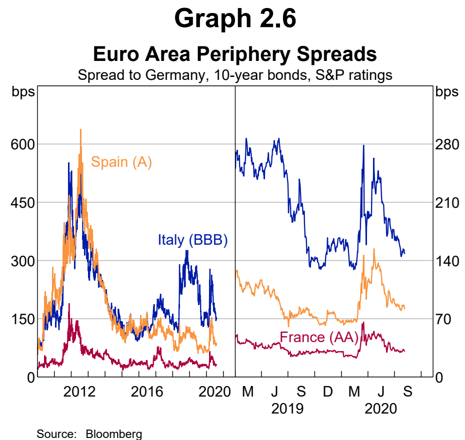
Government bond yields have stabilised around low levels

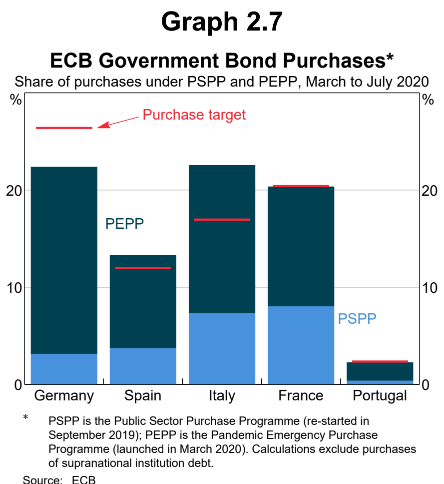
Yields on long-term government bonds are around historical lows in most advanced economies, and volatility has declined (Graph 2.5). After a period of severe dysfunction in March, government bond markets are functioning well. In the market for US Treasuries, the difference between the prices at which bonds can be bought and sold (bid-offer spreads) have largely normalised. At the same time, measures of market depth (such as the volume of bonds that can be transacted at the best bid and offer prices) have improved, but remain below pre-COVID-19 levels. Forward-looking measures of government bond market volatility remain low, despite volatility remaining elevated in a number of other markets and general uncertainty about the outlook for economic activity and the extent of fiscal deficits. Low government bond yields are consistent with the subdued outlook for global inflation and guidance from central banks that asset purchases will continue and policy rates will not increase for some time.

In Europe, spreads on periphery government bonds relative to those on German Bunds have narrowed since the previous *Statement* and are close to their pre-COVID-19 levels, largely in response to the ECB's pandemic-related bond purchases (Graph 2.6). Details released by the ECB indicated that purchases in the first few months of the program were disproportionately weighted towards Italian and Spanish bonds relative to the long-term target for purchases, as those markets came under particular stress and higher spreads would have seen monetary conditions tighten relative to other parts of the euro area (Graph 2.7). ECB officials have stated that this is a natural consequence of the program as it is designed to be flexible enough to address the uncertain and potentially asymmetric effects of the COVID-19 crisis on the markets of individual euro area countries.

The narrowing of spreads in the periphery of the euro area has also reflected recent agreement







among EU member states on a stimulus package in response to COVID-19. The package includes €390 billion in grants and €360 billion in loans to member states, which the European Commission (EC) will finance by issuing €750 billion in debt. This represents a significant increase in EC debt on issue, which is currently around €52 billion and has been used to fund targeted assistance programs.[1]

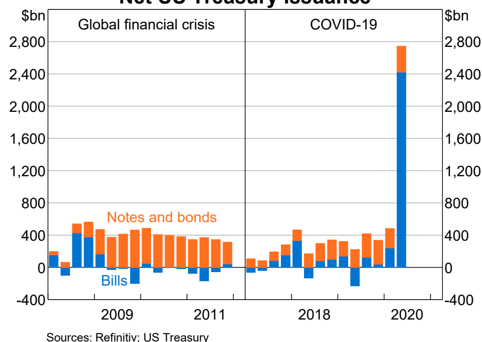
Government debt issuance has increased substantially

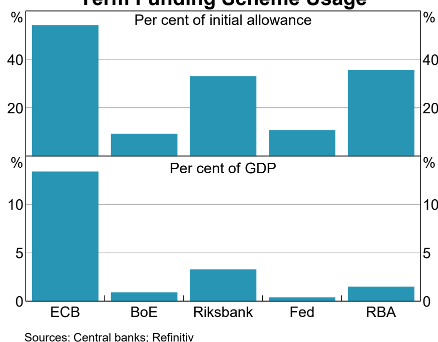
Sovereign debt issuance has increased sharply in recent months. Initially, governments concentrated most new borrowing in more liquid, short-dated instruments; for example, the US Treasury issued around $2.4 trillion in bills during the June quarter (Graph 2.8). However, with conditions now having stabilised, governments are increasingly issuing at longer tenors, much as was observed during the global financial crisis. Relative to shorter-term instruments, long-term bonds carry less rollover and interest rate risk for governments but have a narrower investor base. A further increase in issuance may put upward pressure on long-term bond yields; however, central banks' purchases of longer-term government bonds in secondary markets will offset some of this pressure.

Central banks have introduced programs to reduce the cost and support the flow of funding to businesses

Central banks continue to support the flow of credit to the real economy through lending facilities that provide long-term, low-cost funding for banks, often with incentives to increase lending to the private sector (Graph 2.9).[2] Most recently, the Bank of Japan (BoJ) introduced a facility providing funds to banks based on their lending to small and medium-sized enterprises (SMEs), including loans made under a government loan scheme. In Sweden, the Riksbank eased the terms of its onward lending program by extending loan maturities from two to four years, and reducing the interest rate penalty for failing to lend funds to non-financial companies from 0.2 to 0.1 per cent. In the euro area, the ECB conducted the first of its Targeted Longer Term Refinancing Operations (TLTRO III) at the lower funding rate announced in April. Under the program, banks that maintain their lending are able to borrow funds at a rate as low as –1 per cent. The lower pricing led to a large volume of take-up, reflecting both new borrowing and refinancing of previous ECB loans at a lower interest rate.

Several central banks have also introduced programs to purchase private sector assets in the secondary market. These programs aim to





lower the cost of funding for, and support the flow of financing to, private sector borrowers that raise funds directly (rather than via banks). Following initial announcements in March and April, the Fed and the BoC began purchasing corporate bonds in June. More recently, the Fed extended the duration of its lending and asset purchase programs that were due to expire in September until the end of 2020. The Riksbank will also begin purchasing corporate bonds in September. The BoJ announced in March that it would purchase commercial paper and corporate bonds at an accelerated pace and subsequently extended the duration of these additional purchases by six months to March 2021 as part of a package of measures to support corporate financing. Meanwhile, the BoE and ECB continue to increase their existing holdings of corporate bonds in line with stated purchase targets. Most central banks retain spare capacity to increase corporate bond purchases within existing facilities (Graph 2.10).

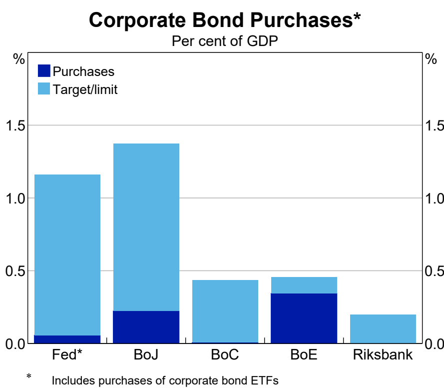
The Fed will also provide targeted credit support to SMEs by purchasing up to US$600 billion in loans made by banks to SMEs through the Main Street Lending Program. The terms of the program, first announced in April, have subsequently been eased to offer more favourable borrowing conditions and support a wider range of firms. The Fed expanded the range of eligible loans and eligible borrowers, increased the term of each loan from four to five years and allowed for delayed principal repayments for two years instead of one. The program became operational in mid June, and has since purchased $82 million in loans.

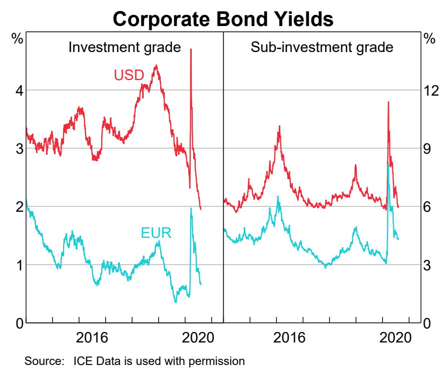
Some central banks have implemented programs to purchase assets in the primary market to improve market functioning and lower borrowing costs. The Fed, for example, has introduced facilities to conduct primary market asset purchases in municipal and corporate debt markets with the intention of stabilising funding conditions. The existence of a credible backstop in these markets has helped to alleviate market dysfunction and the take-up of these facilities has been low.

Corporate funding conditions are favourable

Funding conditions for corporations have eased significantly since March, reflecting substantial fiscal and monetary support. Credit spreads have narrowed and corporate bond yields have fallen back to around pre-COVID-19 levels (Graph 2.11). In the United States and Europe, investment grade borrowers have continued to raise record amounts of debt, and market access has generally improved for lower-quality borrowers.

In addition to significant issuance of bonds, non-financial corporations have raised significant



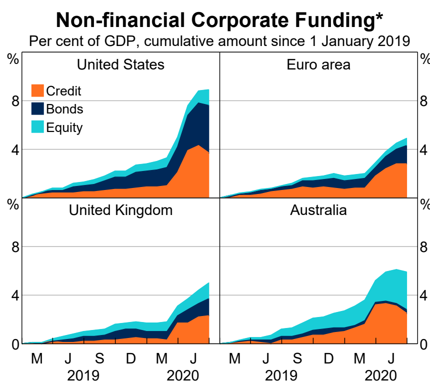


amounts of external funding from other sources since the onset of the pandemic. Business credit rose strongly in the major advanced economies in March and April as corporations drew down on pre-existing credit lines with banks. Listed corporations have also issued record amounts of equity. This is particularly true in Australia, where equity raisings as a proportion of GDP have been higher than in other advanced economies. In contrast, corporations in the United States and the euro area have sourced a larger share of their funding through debt issuance, reflecting the relative size and liquidity of corporate bond markets in those jurisdictions (Graph 2.12).

While funding conditions have eased, a sharp fall in corporate earnings is expected to see a rise in the number of companies that default on their debts. A large number of firms have had their credit ratings downgraded, although the pace of these downgrades has slowed since March (Graph 2.13). Annual default rates for large sub-investment grade borrowers in the United States and Europe have increased to around 3–5 per cent. These defaults have so far been concentrated in a few industries that are most directly exposed to the pandemic and the associated downturn in economic activity, such as the energy, retail, leisure and entertainment sectors. Analysts expect default rates in aggregate to rise further but to remain below the levels of previous economic downturns in part due to significant fiscal spending, temporary debt relief and forbearance, and, in some countries, changes to bankruptcy laws.

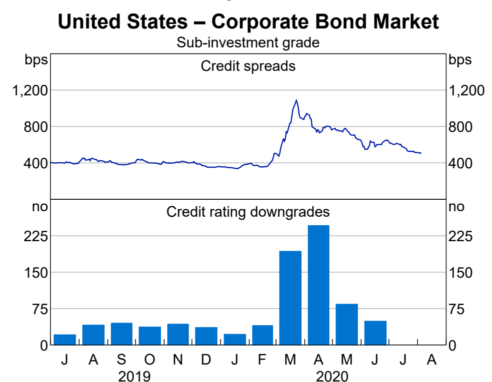
Equity prices have increased, in part because market participants expect the decline in corporate profits to be short-lived

Global equity prices have recovered further in recent months following the extreme volatility of late February and March. Equity prices have risen by around 15 per cent since the previous *Statement* and by around 40 per cent from their recent trough (Table 2.2). Most indices are still below their peaks prior to the pandemic (Graph 2.14). Nonetheless, the recovery in global equity prices suggests recent declines in earnings are expected to be relatively short-lived (discussed below). Prices have also been supported by the significant easing of fiscal and monetary policies, a decline in COVID-19 infections in some parts of the world, and the associated gradual easing of containment measures. The volatility of equity prices has also declined since March, although it remains above long-term averages, in part reflecting concerns about rising COVID-19 cases in some countries.



* Net business credit, net bond issuance and gross equity issuance

Sources: Bank of England; Bloomberg; Dealogic; ECB; Federal Reserve Bank of St. Louis; RBA



Sources: ICE Data is used with permission; S&P Global Market Intelligence

Table 2.2: Changes in International Share Prices

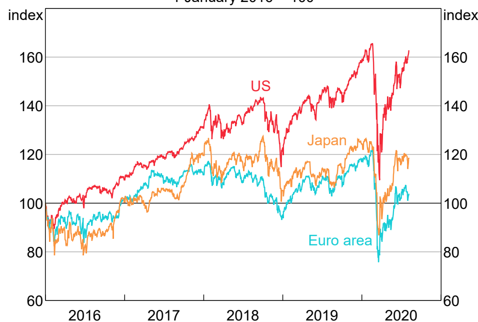
Per cent

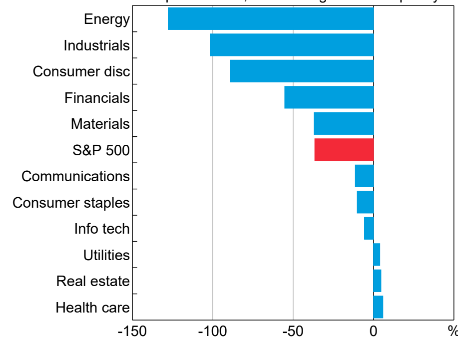
	From previous *Statement*	From recent trough	From pre-COVID-19 peak
United States	15	49	–2
Euro area	12	37	–15
United Kingdom	3	22	–19
Japan	14	36	–6
Australia	12	32	–16
China	21	35	14
World	**14**	**41**	**–5**

Source: Bloomberg

In the United States and Europe, corporate earnings are estimated to have fallen by 40–60 per cent in the June quarter relative to a year ago, the largest decline since the 2008 global financial crisis and among the largest of the past 50 years. While earnings have declined across most sectors, the falls for firms in the energy, consumer discretionary and industrial sectors have been especially large because demand for their output has been more adversely affected by the effects of COVID-19 on economic activity (Graph 2.15).

Despite the fall in corporate earnings, equity prices have recovered much of their losses from earlier in the year. As a result, the ratio of prices to year-ahead earnings have increased to levels well above their long-term averages in a number of advanced economies (Graph 2.16). This suggests that market expectations are that the decline in corporate earnings will be short-lived, supported by significant fiscal and monetary policy stimulus and optimism that a COVID-19 vaccine will be developed. In the United States, equity prices have also been buoyed by strong gains in parts of the technology and consumer discretionary sectors, which have benefited from increased demand for digital goods and services (Graph 2.17).





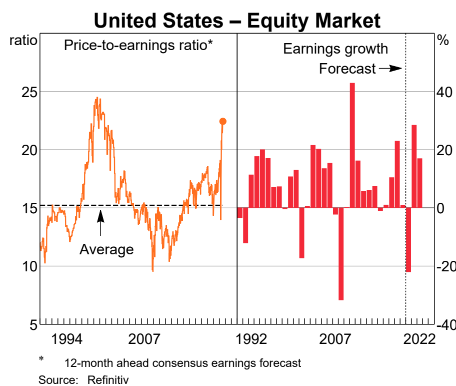
In contrast, the share prices of banks have fallen by more than those in most other sectors because the pandemic is expected to have a large and prolonged effect on banks' profits. Bank profits in advanced economies fell by around 50–70 per cent over the first half of 2020, as provisions for loan losses increased sharply to around the highest levels seen since the global financial crisis. Banks' net interest margins have also declined and are expected to fall further, consistent with an extended period of low interest rates. Despite lower profits, banks have maintained strong capital and liquidity positions throughout this period. This follows significant reforms since the 2008 financial crisis aimed at increasing the resilience of financial institutions, and has allowed banks to act as an important source of funding for households and businesses throughout the pandemic.

The US dollar has depreciated to pre-pandemic levels against a range of advanced economy currencies

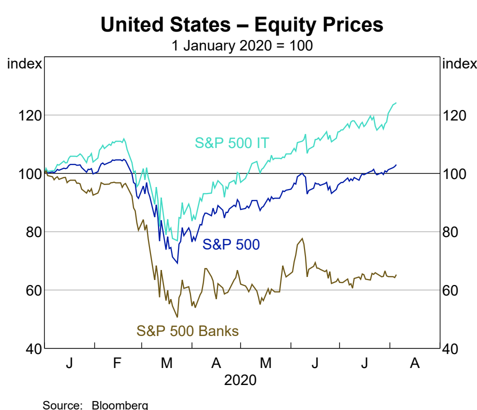
As conditions in foreign exchange markets have stabilised alongside a decline in global risk aversion and the implementation of large-scale monetary stimulus by the Fed, the US dollar has returned to levels around those observed prior to the pandemic against the currencies of other advanced economies (Graph 2.18).[3] However, it still remains higher than earlier in the year against the currencies of a range of emerging market economies as they continue to contend with growing infection rates, lower commodity prices and pre-existing macroeconomic vulnerabilities (see below).

The euro has appreciated over recent months and is around its highest level since 2014, supported by the agreement on the EU recovery fund and as containment measures have been relaxed in the region (Graph 2.19). The Swiss franc has been little changed after appreciating earlier in the year partly because the Swiss National Bank (SNB) has intervened in the foreign exchange market at different points this year to limit further appreciation of the currency.

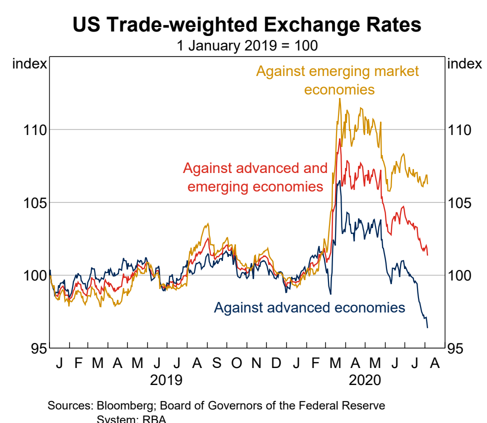
Graph 2.16



Graph 2.17



Graph 2.18



The SNB has reiterated that foreign exchange intervention plays a central role in its policy mix and that it remains willing to intervene further if required. Most other advanced economy exchange rates, including the Australian dollar, have appreciated further over recent months.

The Australian dollar has appreciated to levels a bit above those observed prior to the pandemic

The Australian dollar has appreciated further since the previous *Statement*, having depreciated sharply to US$0.55 in March, which was its lowest level since the early 2000s. It is now around US$0.72 against the US dollar. The depreciation and subsequent appreciation of the Australian dollar were large relative to the movements in the exchange rates of other advanced economies. Conditions in the market for Australian dollars have stabilised and the average daily trading range has returned to levels observed in the period before the pandemic (Graph 2.20).

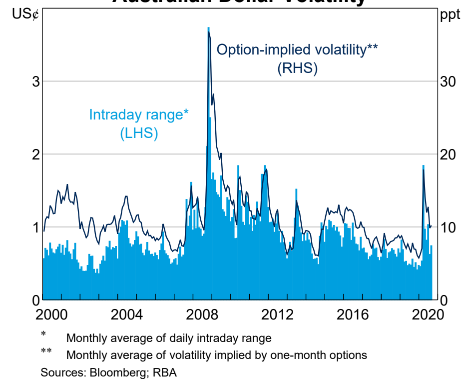
Movements in the Australian dollar have continued to track US equity markets closely over recent months (Graph 2.21). Meanwhile, the prices of Australia's key export commodities have increased since the previous *Statement*, most notably for iron ore, while the yields on Australian Government bonds have been little changed relative to those of the major advanced economies. These medium-term influences on the value of the exchange rate are around or a bit above their levels at the start of the year. Based on historical relationships, the level of the Australian dollar appears broadly consistent with the terms of trade and interest rate differentials (Graph 2.22).[4]

Australia experienced large capital flows in the March quarter

Australia recorded both large capital outflows and inflows in the March quarter, amid stressed conditions in financial markets (Graph 2.23).

Graph 2.20

Australian Dollar Volatility



* Monthly average of daily intraday range

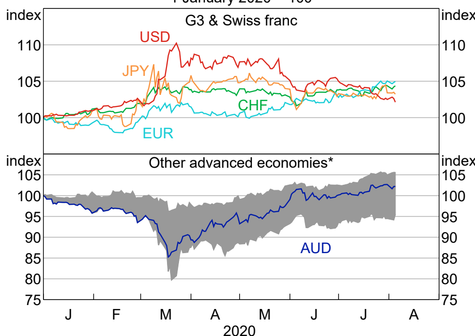
** Monthly average of volatility implied by one-month options

Sources: Bloomberg; RBA

Graph 2.19

Nominal Trade-weighted Exchange Rates

1 January 2020 = 100

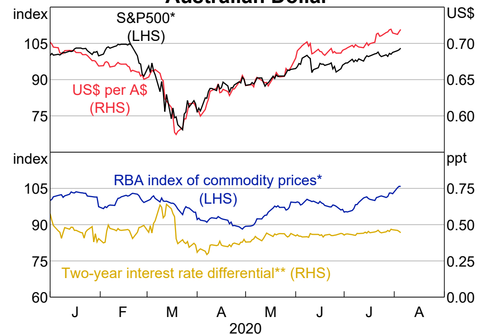


* Shaded area indicates range of other advanced economy TWIs

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

Graph 2.21

Australian Dollar



* Indexed to 1 January 2020 = 100

** Spread to equally weighted nominal yields in Germany, Japan, the United Kingdom and the United States

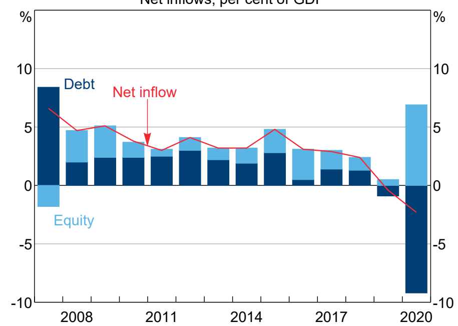
Sources: Bloomberg; RBA

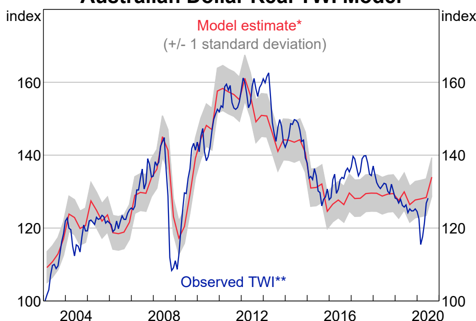
Outflows were mainly driven by the sale of Australian government bonds by non-residents. In part, this reflected an unwinding of trading positions in government bonds by foreign investors. In addition, outflows reflected foreign exchange intervention by a range of central banks in emerging markets, which involved selling bonds, including Australian government bonds, as they supported their exchange rates against depreciation pressures over this period.[5] Capital outflows were partly offset by inflows from superannuation and other investment funds selling-off their holdings of foreign equities. In the superannuation sector, the demand for liquidity was partly in anticipation of some Australians gaining early access to their superannuation. Overall, there was a net outflow of capital in the March quarter, consistent with Australia recording a current account surplus (see 'Domestic Economic Conditions' chapter).

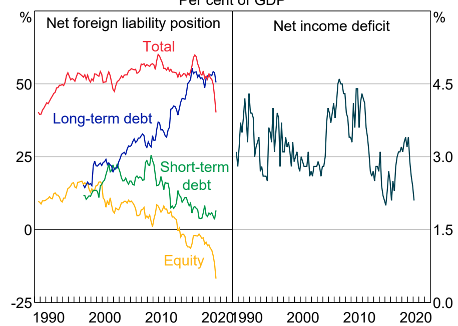
Australia's net foreign liability position, relative to GDP, declined to its lowest level since the early 1990s (Graph 2.24). This decline was driven by an increase in Australia's net foreign equity asset position, mostly owing to valuation effects resulting from the depreciation of the Australian dollar over the March quarter. The net income deficit, which is the difference between income earned from Australia's foreign assets and payments made on Australia's foreign liabilities, narrowed in the quarter to be at its lowest level in a number of years.

Financial conditions in emerging markets have improved …

Financial conditions in a wide range of emerging market economies (EMEs) have continued to improve in recent months, aided by the actions of policymakers globally and a partial recovery in commodity prices. Government bond yields have declined a little further, equity prices have continued to rise, exchange rates have generally appreciated, and portfolio outflows from EMEs have slowed or stopped (Graph 2.25). External







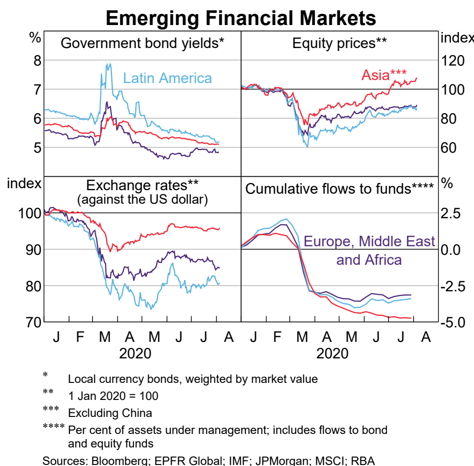
financial conditions have benefited from declines in US dollar funding costs in both government and corporate markets since March. While conditions have improved, the spreads that EMEs pay relative to US Treasuries remain higher and most EME exchange rates remain substantially lower than prior to the pandemic.

Financial market conditions in emerging Asia have generally been more resilient than in other regions. Many EMEs in Asia have contained the virus more effectively than their peers elsewhere, although infections in South Asia have continued to grow. The region also entered the crisis with stronger economic fundamentals, including more fiscal space and faster economic growth. Asian EMEs are generally less exposed to large falls in commodity prices, which have weighed on EMEs in other regions during the present crisis, and many Asian economies have in fact benefited from lower oil prices.

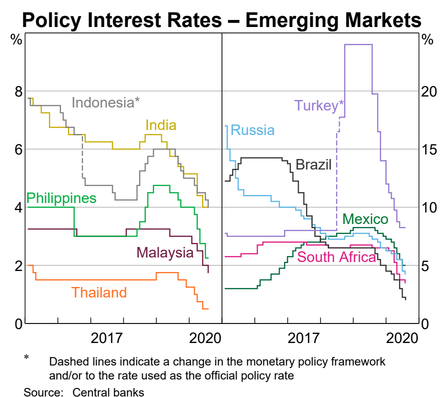
… in part because emerging market central banks have eased policy settings further …

Central banks in emerging markets have provided further policy support, contributing to the improvement in emerging market financial conditions. Emerging market central banks have lowered their policy rates through 2020 as they observed the effects of COVID-19 on their economies (Graph 2.26). During previous crises, concerns about the exchange rate and capital outflows led EME central banks to maintain relatively high policy rates given the deterioration in their domestic economic outlooks. The larger scale easing observed this year reflects both the unusually sharp declines in domestic activity and inflation, and an improvement in the policy frameworks and financial market development in many EMEs. A number of central banks have also continued to buy governments bonds to support market functioning and lower the cost of financing for governments; however, these programs – which are in the order of 0.5–1.5 per cent of GDP – remain much smaller than those in advanced economies.

In addition to its existing bond buying program, Bank Indonesia and the Indonesian Ministry of Finance announced a deficit burden-sharing arrangement where Bank Indonesia will purchase government bonds in the primary market to support the government's fiscal packages. The value of bonds purchased will be between 2½ and 6 per cent of GDP depending on the ultimate form of implementation and the degree of demand for the bonds from investors.



* 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



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

Some EMEs have also launched or extended credit support programs for small and medium-sized enterprises, although the programs are generally small at around 0.5 per cent of GDP. While some central banks have intervened in the foreign exchange market to support their currencies, the scale of intervention has eased in recent months.

… and use of multilateral financing arrangements has increased

Despite the improvement in financial conditions, EMEs continue to contend with the interaction of long-standing vulnerabilities with the current health and economic crisis. Concerns remain about the ability of some EMEs to finance large fiscal deficits, the reliance of some on external financing and unhedged foreign currency exposures. In recent months, many EMEs have experienced a rapid increase in the spread of COVID-19, including Brazil and South Africa. Both countries also entered the crisis with low and declining rates of economic growth, elevated levels of government (and state-owned enterprise) debt and relatively large fiscal deficits.

Multilateral measures have continued to support low-income countries and EMEs during the crisis. The International Monetary Fund has approved an unprecedented number of funding arrangements since late March, with the vast majority relating to emergency financing for low-income countries and smaller EMEs (Graph 2.27). Some larger EMEs have also received assistance from the IMF; for example, Nigeria and South Africa have received rapid financing loans, Egypt and Ukraine have received non-emergency conditional loans, while Chile, Colombia and Peru have had precautionary credit lines approved (but have not drawn down on these lines). In addition, the G20's Debt Service Suspension Initiative has granted debt forbearance to around 40 low-income countries. Some EMEs, particularly in Asia, have taken loans with other supranational organisations to help finance government programs, including funds specifically tied to SME support. For example, India and Indonesia will each borrow US$2.25 billion through loans from the Asian Infrastructure Investment Bank and Asian Development Bank.

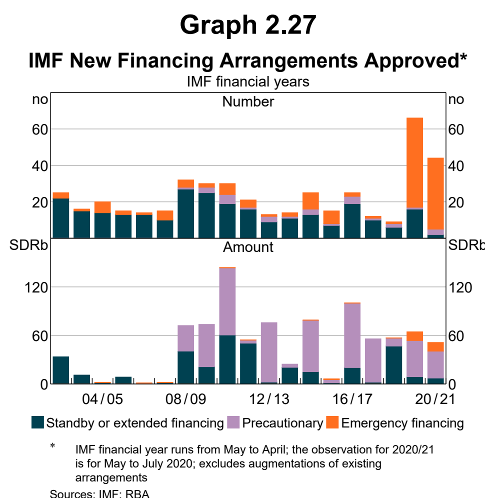
Chinese policymakers are ensuring financial conditions remain accommodative, but are mindful of financial stability risks

Financial conditions remain broadly accommodative in China. Policymakers are focused on maintaining the flow of credit to the economy, and in turn supporting growth and employment. At the same time, however, the cost of debt has risen of late and policymakers are attentive to the potential for risks to build in parts of the financial system, particularly via off-balance sheet and non-bank financing.

Accordingly, monetary easing this year has been relatively modest and measures announced since May have been targeted at encouraging the provision of credit to smaller firms. In June, the People's Bank of China (PBC) cut the interest rates offered to financial institutions as part of their programs aimed at supporting bank

Graph 2.27

IMF New Financing Arrangements Approved*



* IMF financial year runs from May to April; the observation for 2020/21 is for May to July 2020; excludes augmentations of existing arrangements

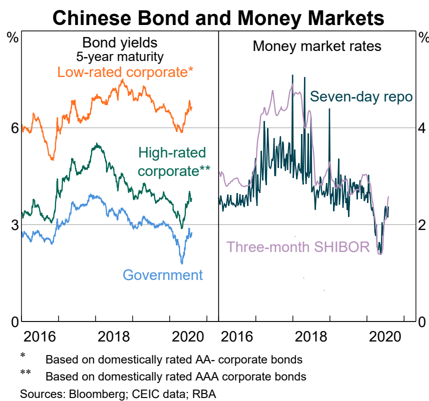
Sources: IMF; RBA

lending to micro and small enterprises, and established two new modestly sized funding facilities to support further lending to these firms. Micro and small enterprises account for a large proportion of employment in China and are relatively reliant on bank credit.

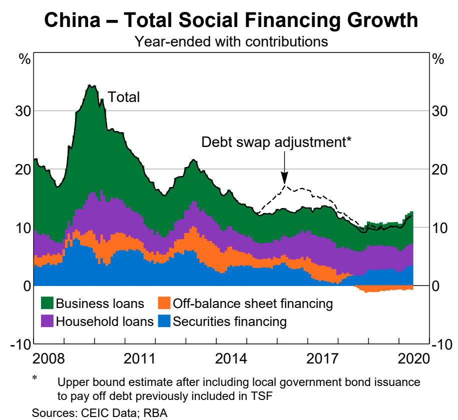
While the PBC has not adjusted any of its broader policy rates since April, it has allowed liquidity conditions to tighten and money market interest rates to rise (Graph 2.28). Money markets are a particularly important source of funding for some shadow finance in China and the slight rise in money market rates will help to curtail some of that activity that had been rising modestly in recent months. This is consistent with the attempt of the authorities to reduce the activities of non-bank financial institutions over recent years.

The price of longer-term credit in the corporate bond market has also risen since late May. This reflects a combination of factors, including: improved economic outcomes; a moderation in expectations of future easing by the PBC; an increase in government bond issuance; and the increase in money market rates. Nevertheless, growth in overall credit appears consistent with authorities' intentions. In particular, growth in total social financing has remained stronger than a year ago, in line with the announcement at this year's National People's Congress that credit would grow at 'notably higher rates than last year' (Graph 2.29). The faster pace of growth owes primarily to bank lending to businesses and corporate bond issuance. That said, while the banking system has been able to maintain the flow of credit during the current crisis, China's banking regulator recently warned that risks from rising non-performing loan ratios remain high. These risks are more prominent for smaller banks, which were facing increased concern about their asset quality and capital adequacy even prior to the outbreak of COVID-19. Authorities have announced a number of measures to support smaller banks throughout the crisis. For example, CNY200 billion of the 2020 local special bond quota (around 0.2 per cent of GDP) has been allocated to replenishing the capital of small- and medium-sized banks.

Chinese equity prices increased sharply in early July and have remained relatively volatile since (Graph 2.30). Better-than-expected economic data and a continued low level of domestic COVID-19 cases supported the increase in prices, though encouraging statements from the state media also appeared to be an important factor. Historically, China's equity market has been prone to bouts of investor speculation led by the large share of retail investors in the market and widespread perceptions of state support for the



* Based on domestically rated AA- corporate bonds
** Based on domestically rated AAA corporate bonds
Sources: Bloomberg; CEIC data; RBA

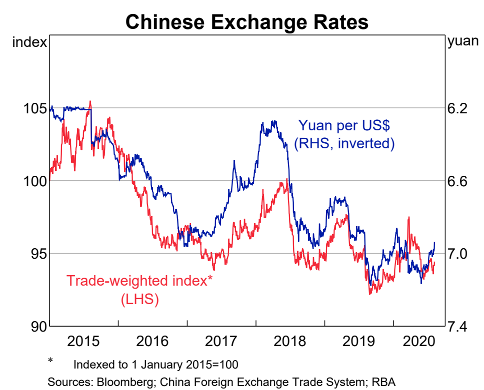


* Upper bound estimate after including local government bond issuance to pay off debt previously included in TSF
Sources: CEIC Data; RBA

market. In this episode, share market turnover has increased and leverage in the market has risen, although the increase has been much smaller than during the sharp rise and then decline in equity prices around 2015. Price growth has moderated in recent weeks and more recent state media statements and actions by regulators suggest a desire to contain the growth of leverage.

The Chinese renminbi has been stable amid ongoing geopolitical and trade tensions

The Chinese renminbi has been little changed over recent months, despite further tensions between the United States and China (Graph 2.31). The relative stability of the renminbi compared with other exchange rates since the start of the year is consistent with the more managed nature of the currency, although international trade and portfolio inflows are also likely to have contributed to the stability of the exchange rate since March. Meanwhile, China appears to have taken several additional steps in the direction of liberalising its capital account following announcements that some foreign investment restrictions have been eased recently. ✠



Endnotes

[1] The European Investment Bank, which is jointly owned by EU member states, and the European Stability Mechanism and the European Financial Stability Fund, which are jointly owned by euro area member states, collectively have around €780 billion in outstanding debt.

[2] See RBA (2020), 'Box A: Term Funding Schemes', *Statement on Monetary Policy*, May, pp 31–33. Available at <https://www.rba.gov.au/publications/smp/2020/may/box-a-term-funding-schemes.html>

[3] For more information on developments in foreign exchange markets during the COVID-19 crisis, see Reserve Bank of Australia (2020), 'Box B: Recent Developments in Foreign Exchange Markets', *Statement on Monetary Policy*, May. Available at <https://www.rba.gov.au/publications/smp/2020/may/box-b-recent-developments-in-foreign-exchange-markets.html>. and <https://www.rba.gov.au/publications/smp/2020/may/box-b-recent-developments-in-foreign-exchange-markets.html>

[4] For more information on the key determinants of the Australian dollar and the Reserve Bank's forward-looking model of the real TWI, see Chapman B, J Jaaskela and E Smith (2018), 'A forward-looking Model of the Australian Dollar', RBA *Bulletin*, viewed 17 July 2020. Available at <https://www.rba.gov.au/publications/bulletin/2018/dec/a-forward-looking-model-of-the-australian-dollar.html>. and <https://www.rba.gov.au/publications/bulletin/2018/dec/a-forward-looking-model-of-the-australian-dollar.html>

[5] For more information see Debelle, G (2020) 'The Reserve Bank's Policy Actions and Balance Sheet' Speech at the Economic Society of Australia, Online, 30 June. Available at <https://www.rba.gov.au/speeches/2020/sp-dg-2020-06-30.html> and <https://www.rba.gov.au/speeches/2020/sp-dg-2020-06-30.html>