3. Domestic Financial Conditions

The policy measures implemented by the Reserve Bank from the start of the pandemic have lowered funding costs to very low levels across the economy. The measures include the reductions in the cash rate, the use of forward guidance, the target for the yield on the 3-year Australian Government bond, the Term Funding Facility (TFF) and the bond purchase program. Low funding costs have, in turn, flowed through to historically low interest rates on housing and business loans. The measures have also supported the availability of credit to households and businesses. Demand for housing finance has been picking up, while demand for new business loans has increased a little over recent months.

While longer-term government bond yields have risen since earlier this year, in line with global developments, the yield on the 3-year Australian Government bond remains anchored at the 10 basis point target. Conditions in Australian government bond markets were strained in late February and early March 2021 as the improving global economic outlook saw market participants bring forward their expectations of policy rate increases and led to sharp increases in longer-term government bond yields globally. However, the strains were moderate compared with those in early 2020 at the onset of the pandemic, and conditions improved later in March as bond yields stabilised. The Bank brought forward some of its purchases under the bond purchase program to assist with market functioning at that time. Overnight indexed swap prices imply that market participants expect the cash rate to remain around its current low rate for the coming 2 years and increase to around 50 basis points over 2023.

By lowering the structure of interest rates across the economy, the Reserve Bank's policy measures announced in 2020 have contributed to a lower exchange rate than otherwise. The global economic recovery has continued to support the prices of a number of Australia's key commodity exports, and the Australian dollar has moved within a reasonably narrow range since the start of the year.

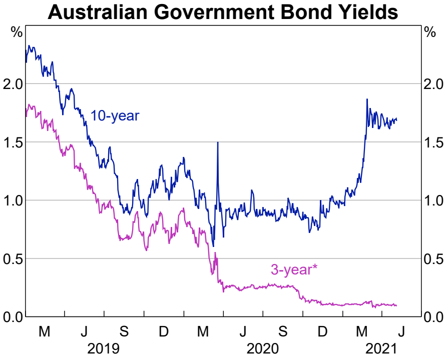
Longer-term AGS yields have risen alongside global bond yields …

Yields on longer-term Australian Government Securities (AGS) rose sharply through February, alongside a broad increase in global yields associated with the improved global economic outlook (Graph 3.1). Market conditions were strained as yields rose, but improved through March as long-term AGS yields settled (see below). US Treasury yields rose steadily through February and March as positive COVID-19 vaccination developments and the passing of the large US fiscal stimulus package supported the improvement in the economic outlook. As a result, after rising to around 40 basis points at the end of the February, the spread between 10-year AGS and US Treasury yields has narrowed to around zero, where it had been in late 2020 and early 2021 (Graph 3.2).

The increase in medium-term AGS yields over recent months has been driven by an increase in inflation compensation, as investors anticipate a pick-up in inflation over the next few years. Longer-term yields have increased due to a combination of higher inflation expectations and higher real yields, reflecting the strengthening economic outlook and the associated increases in longer-term policy rate expectations. The expected increase in inflation implied by market pricing is consistent with inflation increasing from the very low levels of 2020 to be broadly in line with the RBA's inflation target.

Graph 3.1

Australian Government Bond Yields



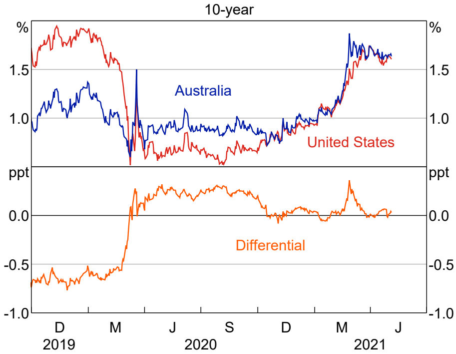
* 3-year yield target bond is the April 2023 Treasury bond until 20 October 2020, and the April 2024 Treasury bond thereafter

Sources: RBA; Yieldbroker

Graph 3.2

Government Bond Yields

10-year



Sources: Bloomberg; RBA; Yieldbroker

… while the 3-year Australian Government bond yield remains anchored at the target of around 10 basis points

The yield on the 3-year Australian Government bond rose modestly in late February, alongside the more pronounced rise in longer-term AGS yields. Some market participants had thought that the Bank might not maintain the yield target for much longer, and had short-sold the bond in anticipation of this, further contributing to the rise in yield.

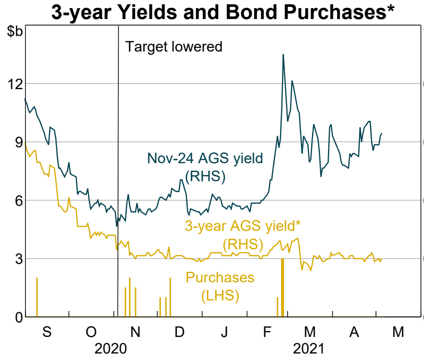
The Bank purchased $7 billion of the April 2023 and April 2024 bonds across 3 auctions in late February to support the yield target, and a speech by the Governor in early March emphasised the Bank's commitment to the 3-year yield target of around 10 basis points. He indicated that the Board would make a decision later in the year to either keep the April 2024 bond as the target bond, or extend the yield target to the November 2024 bond. In early March the Bank also increased the fee that it charges counterparties to borrow the 3-year target bond – from 25 to 50 and then to 100 basis points – which made short-selling the bond more costly. These developments saw an increase in demand for the target bond, and the yield subsequently settled back to the target (Graph 3.3).

The yield on the November 2024 bond increased in late February, reaching around 45 basis points, compared with around 20 basis points in preceding months, before declining as market conditions stabilised and market functioning improved over the second half of March. Nonetheless, the yield on the November 2024 bond remains around 30 basis points, suggesting that market participants on average do not expect the Bank to extend the yield target to the November 2024 bond.

While the targeted 3-year AGS yield has been little changed, 3-year yields in other domestic markets rose over the first few months of this year alongside the global sell-off in bond markets (Graph 3.4). In particular, the 3-year swap rate rose and has remained at those higher levels. This higher swap rate has flowed through to other yields which typically price off swaps, including bank and corporate bonds (see below). There is generally a positive spread between swap rates and AGS yields, reflecting greater credit risk, but the larger spread between the swap rates and AGS yields at around the 3-year tenor reflects the different expectations for the cash rate as implied by overnight indexed swap (OIS) rates and the Bank's guidance for the cash rate target at this horizon (see below).

Graph 3.3

3-year Yields and Bond Purchases*



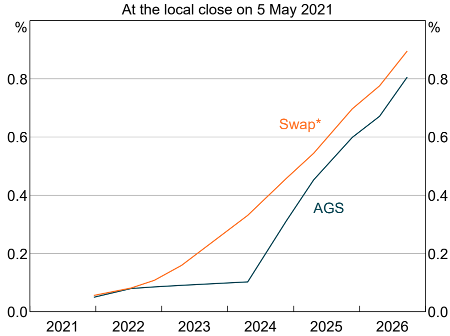
* 3-year yield target bond is the April 2023 Treasury bond until 20 October 2020, and the April 2024 Treasury bond thereafter

Sources: RBA; Yieldbroker

Graph 3.4

AGS Yield and Swap Curves

At the local close on 5 May 2021



* Maturity matched to AGS bond lines

Source: Bloomberg

Market functioning was strained as bond yields rose, but subsequently improved

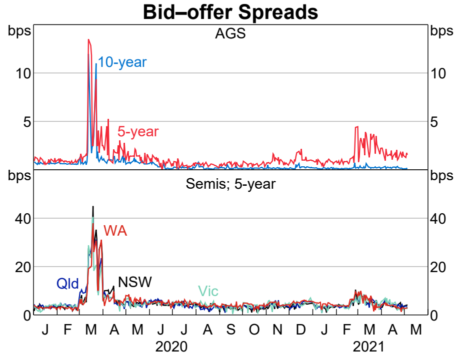
The functioning of government bond markets in Australia deteriorated in late February and over the first weeks of March as bond yields increased sharply and a number of market participants sold their bond holdings. However, the strains were not as severe as those in early 2020 at the onset of the pandemic, and markets stabilised relatively quickly.

The market strains were apparent in a number of indicators. Bid-offer spreads increased for both AGS and securities issued by the state and territory borrowing authorities (semis), although this increase was less pronounced at the longer end of the curve (Graph 3.5).

Market contacts also noted a worsening in liquidity conditions in bond futures markets. Indeed, the bond futures basis – the difference between the implied yield on a futures contract and the yield on the bonds underlying the contract, adjusted for the cost of financing the bonds – widened sharply in late February and early March (Graph 3.6). The futures basis then narrowed a little as market conditions settled following the stabilisation in AGS yields. The Bank also brought forward some of its purchases under the bond purchase program to assist with

Graph 3.5

Bid–offer Spreads



Sources: RBA; Yieldbroker

market functioning, with one larger-than-usual bond purchase operation in early March.

Government bond issuance continues to be met by strong demand

Demand for securities issued by the Australian Office of Financial Management (AOFM) remains strong, with the mid-April syndication of $14 billion of a new November 2032 bond attracting an order book of $48 billion. Semis issuance has also continued to be well-absorbed by markets. Market economists' expectations of the funding needs of the AOFM and state issuing authorities for the remainder of the calendar year have declined given better-than-expected economic conditions.

The AOFM and semi-government issuing authorities responded to the strains in market functioning by temporarily slowing the pace of issuance. The AOFM issued only $1 billion of nominal bonds in each of the first 2 weeks of March, in contrast to an average of around $2½ billion per week earlier in the year. State and territory borrowing authorities, which in general remain ahead of their funding schedules, also avoided large tenders through this period.

Spreads between the yields on semis and AGS widened a little, but stabilised over March as market strains eased and demand for semis picked up (Graph 3.7). Semis spreads remain a little wider than earlier in the year, consistent with the widening in the spreads of swaps to AGS over this period, particularly at the tenors of 3 to 5 years.

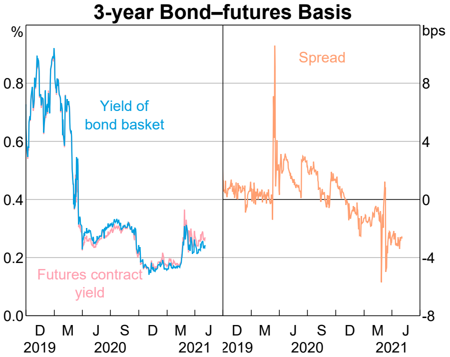
The first phase of the Bank's bond purchase program has concluded and the second phase is under way

The Bank has purchased $120 billion of longer-term bonds under the bond purchase program since early November, consisting of $96 billion of AGS and $24 billion of semis. The Bank now holds 22 per cent of outstanding AGS and 10 per cent of outstanding semis (Graph 3.8). These shares are projected to increase to around 30 and 15 per cent respectively by early September following completion of the second $100 billion of bond purchases announced at the February Board meeting. Purchases have been at a pace of around $5 billion per week, except for one instance in early March when an additional $2 billion of bonds were purchased to provide further support during the period when market conditions were strained, as discussed above.

Auctions under the bond purchase program have been well subscribed, although coverage ratios moved a little lower in March. The Bank decided to adjust the format of the semis auctions in response to declining coverage in

Graph 3.6

3-year Bond–futures Basis

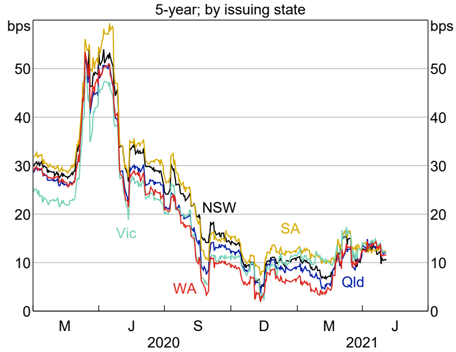


Sources: RBA; Thomson Reuters

Graph 3.7

Semi-government Bond Spreads to AGS

5-year; by issuing state



Sources: RBA; Yieldbroker

these auctions, with weekly semis auctions now conducted across the 5-10 year tenors, rather than alternating between different segments of the yield curve.

The TFF continues to provide low-cost term funding to the banking sector

The TFF is providing low-cost term funding to banks and an incentive for banks to increase lending to businesses, particularly small- and medium-sized enterprises (SMEs).[1] This funding is helping to keep broader funding costs and lending rates at historic lows.

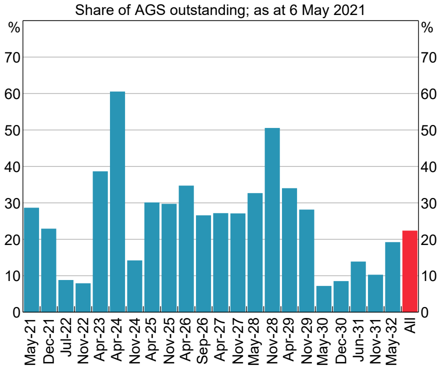
Total funding available under the TFF is around $200 billion as of May 2021, which is about 7 per cent of outstanding credit (Graph 3.9). This includes: drawings under the initial allowance; funding available under the additional allowance (linked to banks' new lending to businesses); and the supplementary allowance made available in October 2020. Increases in SME lending by some banks since March 2020 account for the bulk of additional allowances.

In aggregate, banks have drawn around $102 billion in TFF funding to date. The end of the drawdown window is 30 June 2021 and usage has picked up in recent months, although at a bit less than the pace prior to the closure of the drawdown window for the initial allowance at the end of September 2020 (Graph 3.10). Nevertheless, many banks have indicated in liaison that they plan to take up most if not all of their remaining allowances. The increase in the swap rate in mid March lowered the cost of hedging TFF drawdowns (from fixed rate to variable rate), increasing the attractiveness of the facility. Given that the facility provides funding for 3 years, it will continue to help keep funding costs in Australia low until mid 2024.

Graph 3.8

RBA AGS Holdings*

Share of AGS outstanding; as at 6 May 2021

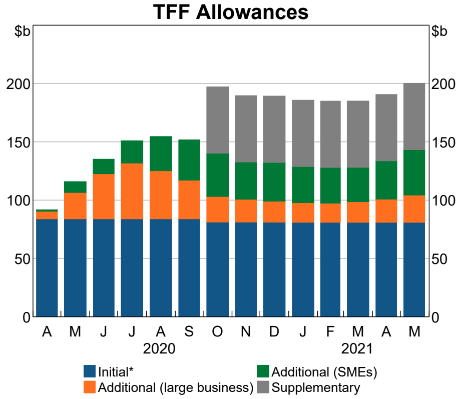


* Excludes holdings under repo; excludes linkers

Sources: AOFM; RBA

Graph 3.9

TFF Allowances



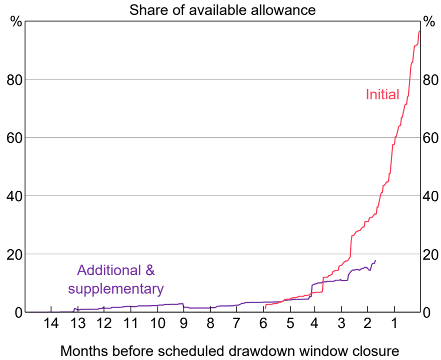
* Represents final usage from October 2020 onwards, as the drawdown period for the initial allowance closed on 30 September 2020

Sources: APRA; RBA

Graph 3.10

TFF Drawdowns

Share of available allowance



Sources: APRA; RBA

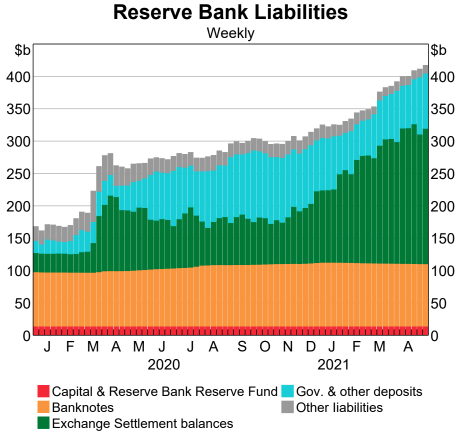
The Bank's balance sheet and liquidity in the banking system have continued to increase

The Bank's policy measures have resulted in substantial and ongoing growth in the Bank's balance sheet, which has more than doubled in size since the onset of the pandemic. Growth in the Bank's assets has reflected an increase in holdings of AGS and semis – reflecting the Bank's bond purchases – and an increase in securities provided as collateral under the TFF (Graph 3.11). This has been partly offset by a decline in securities provided as collateral in open market operations (OMO). On the liabilities side, exchange settlement (ES) balances have risen significantly as a result of the Bank's policies (Graph 3.12; discussed below). Australian Government deposits held at the Reserve Bank have also grown since the onset of the pandemic, as net issuance of AGS has exceeded net government spending over this period.

The size of the balance sheet is expected to grow further over the coming months, as banks continue to draw down TFF funding and the Bank's program of bond purchases continues.

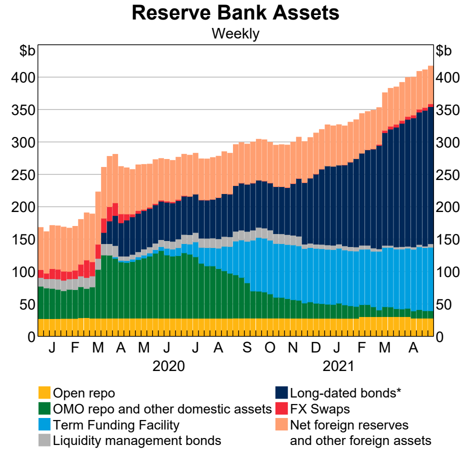
Liquidity in the banking system – as measured by ES balances held at the Reserve Bank – has continued to increase over recent months, reflecting the Bank's purchases of government bonds and lending under the TFF (Graph 3.13). Partly offsetting this, the amount of liquidity provided via OMO has continued to decline, as the high level of system liquidity has reduced demand for this short-term funding. Government flows have also reduced system liquidity, because net issuance of AGS has exceeded net spending by the Australian Government over this period (Graph 3.14).

Graph 3.12



Source: RBA

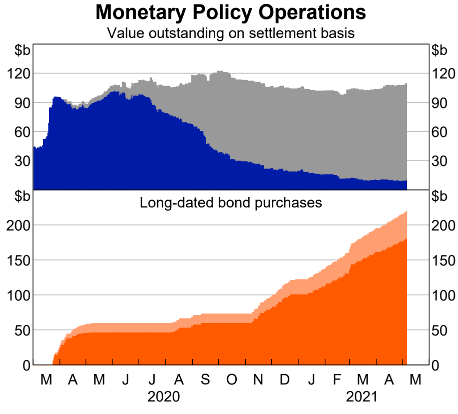
Graph 3.11



* Purchased under programs announced in March and November 2020

Source: RBA

Graph 3.13



* Liquidity injections net of drains and maturities; contracted in OMOs, FX swaps and short-dated bond purchases

Source: RBA

Market participants expect the cash rate to increase by the end of 2023

The cash rate has remained very low, at 3 basis points in recent months, and activity in the cash market has been subdued, owing to the elevated level of system liquidity. Cash market activity was sufficient to publish a cash rate based on market transactions on around 40 per cent of the days over the past 3 months; on other days expert judgement under the fall-back arrangements was used instead. Prices for OIS contracts imply that market participants on average expect the cash rate will remain at or below 10 basis points this year and next, before rising to around 50 basis points by the end of 2023 and a little over 1 per cent by 2024 (Graph 3.15).

Money market rates remain very low

Short-term money market rates remain near historical lows, reflecting the very low level of the cash rate and the large amount of liquidity in the banking system. Bank bill swap rates (BBSW) have risen modestly in recent months, with 6-month BBSW increasing from around 2 basis points in late February to around 10 basis points in early May (Graph 3.16). This was associated with banks raising more funding from this market. The cost of Australian dollar funding sourced via offshore short-term issuance and the foreign exchange swap market has increased a little, making it relatively more attractive to seek short-term funding from the domestic bank bill market. Repo rates at the Bank's daily OMO remained at 10 basis points; repo rates in the private market are reported to be slightly below this level.

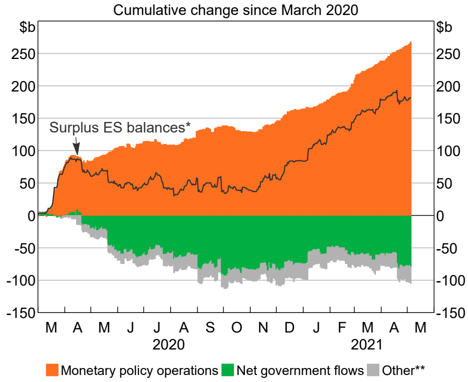
Banks' bond yields increased recently, while issuance remained low

Secondary market yields on bank bonds with maturities of 3-years have increased by around 15-20 basis points since the beginning of 2021 but remain at very low levels. The rise occurred in line with the increase in 3-year swap

Graph 3.14

Exchange Settlement Balances

Cumulative change since March 2020



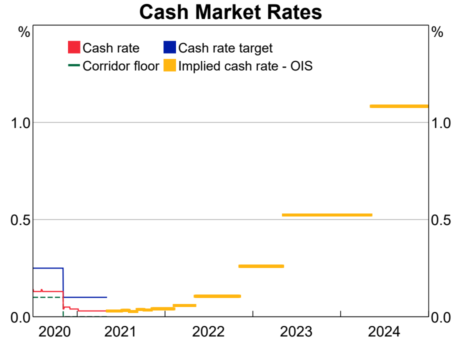
* Total ES balances net of contracted open repo positions

** Includes net banknote issuance and other RBA client flows

Source: RBA

Graph 3.15

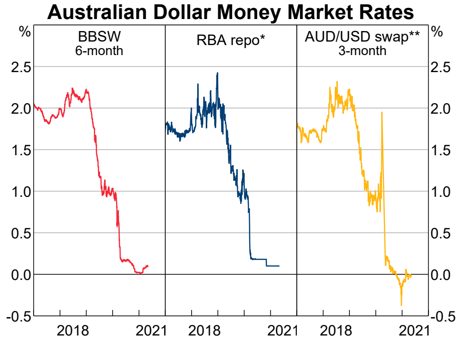
Cash Market Rates



Sources: Bloomberg; RBA

Graph 3.16

Australian Dollar Money Market Rates



* Weighted average rate for morning open market operation repos

** Implied AUD cost via commercial paper issuance and a cross-currency swap

Sources: ASX; Bloomberg; RBA; US Federal Reserve rates in February, with the spread to swap relatively unchanged in 2021 around historic lows (Graph 3.17).

Senior bank bond issuance remained low in 2021 (Graph 3.18). The low level of bond issuance reflected the availability of low-cost funding from the TFF, strong deposit growth and the relatively slow pace of overall credit growth over much of the past year. Meanwhile, Australian banks have continued to issue Tier 2 hybrid securities in 2021, raising $9.2 billion in domestic and offshore markets. Hybrid securities have both equity and debt features and can be used to fulfil a part of regulatory capital requirements, which will increase in January 2024. Spreads on Tier 2 hybrid securities issued by the major banks have narrowed recently and are at the lowest level seen in the past few years (Graph 3.19).

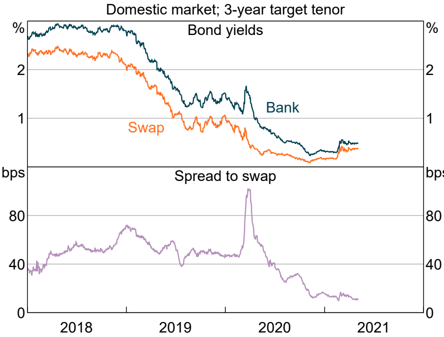
Strong RMBS issuance by non-banks continued into 2021

Issuance of asset-backed securities (ABS) by non-banks was high over the past year, while issuance by banks was quite low. The high level of non-bank residential-mortgage backed securities (RMBS) issuance has pushed the outstanding stock of Australian non-bank ABS above that of bank ABS (Graph 3.20).

Graph 3.17

Bank Bond Pricing

Domestic market; 3-year target tenor



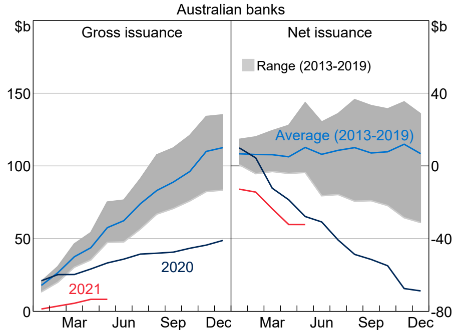
Sources: Bloomberg; RBA

Spreads on RMBS have narrowed significantly for both non-banks and banks in recent months, falling well below pre-pandemic levels. Spreads

Graph 3.18

Cumulative Bank Bond Issuance

Australian banks

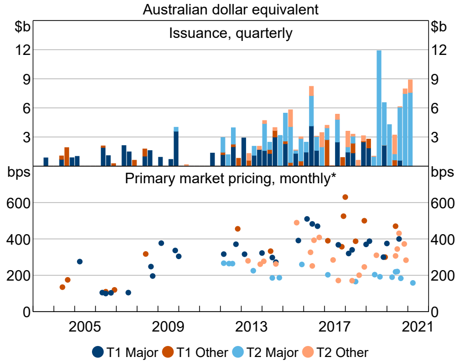


Sources: Bloomberg; Private Placement Monitor; RBA

Graph 3.19

Hybrid Issuance by Australian Banks

Australian dollar equivalent

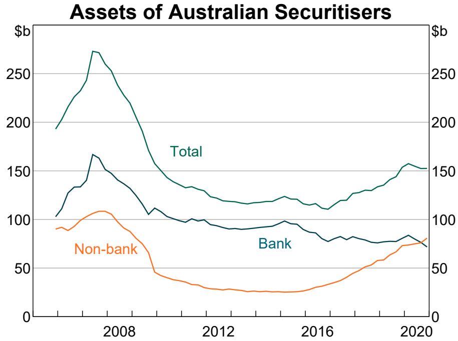


* Face-value weighted average fo the primary market spread to BBSW. Tier 2 deals hedged to first call date

Sources: Bloomberg; KangaNews; RBA

Graph 3.20

Assets of Australian Securitisers



Sources: ABS; RBA

on RMBS are at their lowest level since 2007 (Graph 3.21). Market commentary suggests that the low levels of bank bond issuance are contributing to these low spreads, as investors are moving into other securities, including RMBS, viewed as substitute investments for bank bonds.

Since the March 2020 announcement of the Structured Finance Support Fund (SFSF), the AOFM has provided funding to securitisation warehouses and has invested directly in ABS in the primary and secondary markets. These measures supported the improvement of conditions in the ABS market since then. The AOFM has not made any new SFSF investments since November 2020.

Deposit rates have declined further

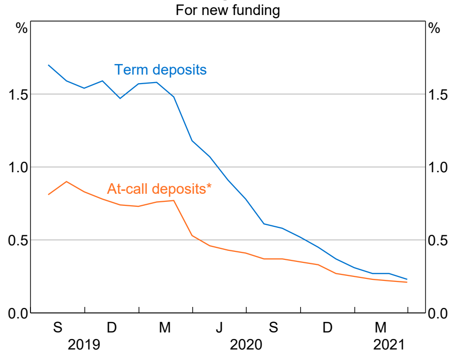
Banks have reduced deposit rates further in response to the plentiful supply of funding at low rates. Interest rates for new term deposits have declined by around 10 basis points since the start of 2021 and by around 135 basis points over the past year or so. Interest rates for at-call deposits have fallen by around 55 basis points over the past year or so (Graph 3.22). The decline in the spread between interest rates on term deposits and other deposit rates is encouraging a shift by customers from term to at-call deposits. At-call deposits now account for around 80 per cent of total deposits, compared with around 70 per cent at the end of February 2020.

These developments have led to an increase in the share of major bank deposits paying low interest rates (that is interest rates between zero and 25 basis points). A little more than one-third of the debt funding of major banks was in the form of deposits paying interest rates of 25 basis points or less at the end of February 2021 (Graph 3.23). This compares with a little over one-quarter in the September quarter 2020 and around 15 per cent in late 2019.

Graph 3.22

Banks' Deposit Rates

For new funding



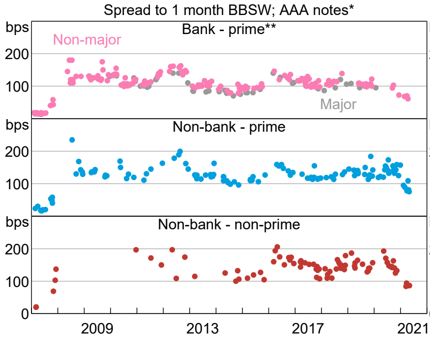
* Excludes deposits in housing loan offset accounts; includes non-interest bearing deposits

Sources: APRA; RBA

Graph 3.21

Primary Market RMBS Pricing

Spread to 1 month BBSW; AAA notes*



* Face-value weighted average of the primary market spread to BBSW for AAA-rated notes

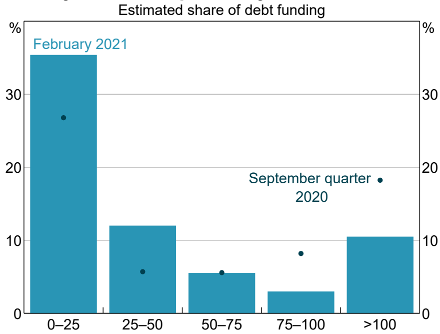
** Prime deals only; excludes a small number of non-prime deals

Sources: Bloomberg; RBA

Graph 3.23

Major Bank Deposits by Interest Rate*

Estimated share of debt funding



* Includes deposits in housing loan offset accounts

Sources: APRA; Bloomberg; Major bank liaison; RBA; Refinitiv

Banks' overall funding costs are at historic lows

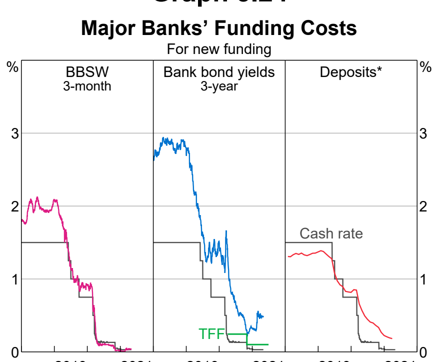
The Reserve Bank's policy measures have lowered banks' funding costs to historically low levels (Graph 3.24). Banks' non-equity funding costs are estimated to have declined by slightly more than the cash rate since the end of February 2020. Much of the banks' wholesale debt and deposit costs are ultimately linked (either directly or via hedging) to BBSW rates, which have declined by around 75 basis points since the end of February last year. As noted above, low-cost funding from the TFF, deposit inflows and modest loan growth have reduced banks' need to seek new wholesale funding, with the cost of new 3-year bank bonds higher than the rate on TFF borrowing. The increase in bank bond yields in February had little impact on major banks' funding costs as new bond issuance remained subdued. Banks' funding costs are expected to decline a little further over the period ahead. This reflects further reductions in banks' deposit rates and wholesale debt costs (as older, more expensive funding matures), as well as expected drawdowns of low-cost TFF funding.

Large deposit inflows have seen the deposit share of banks' total funding (including equity) increase by around 5 percentage points since the end of February 2020 (Graph 3.25). The stock of deposits in the banking system has increased significantly over the past year. The Reserve Bank's purchases of government bonds have contributed to deposit growth because payments for bonds purchased from the private (non-bank) sector are credited to the deposit accounts of the sellers of these bonds. The rising share of low-cost funding from the TFF and deposits has been matched by a reduction in the share of wholesale debt funding.

Interest rates on housing loans have declined further

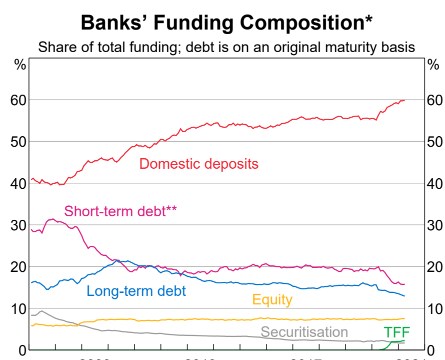
The decline in funding costs since the end of February 2020 has flowed through to housing interest rates paid by borrowers. The average interest rate on outstanding variable-rate mortgages has declined by around 50 basis points since February 2020 (Graph 3.26; Table 3.1). Much of that decline occurred in March and April of last year, as lenders reduced their standard variable rates (SVRs) in March 2020 following the Reserve Bank's initial package of policy measures. Outstanding variable rates have continued to drift lower since then as new and refinancing borrowers have obtained lower rates. The average interest rate on outstanding fixed-rate mortgages has declined by

Graph 3.24



* RBA estimates; excludes deposits in housing loan offset accounts
Sources: AFMA; APRA; ASX; Bloomberg; major banks' websites; RBA; Refinitiv

Graph 3.25



* Adjusted for movements in foreign exchange rates
** Includes deposits and intragroup funding from non-residents
Sources: ABS; APRA; Bloomberg; RBA; Refinitiv

Table 3.1: Average Outstanding Housing Rates
March 2021

	Interest rate Per cent	Change since February 2020 Basis points
All housing loans	3.08	–66
Variable-rate loans		
– Owner-occupier	3.11	–47
– Investor	3.45	–51
All variable-rate loans	3.23	–48
Fixed-rate loans		
– Owner-occupier	2.55	–118
– Investor	2.96	–105
All fixed-rate loans	2.71	–115
By repayment type[(a)]		
– Principal-and-interest	2.98	–64
– Interest-only	3.60	–62

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

significantly more, to be around 115 basis points below its level at the end of February 2020.

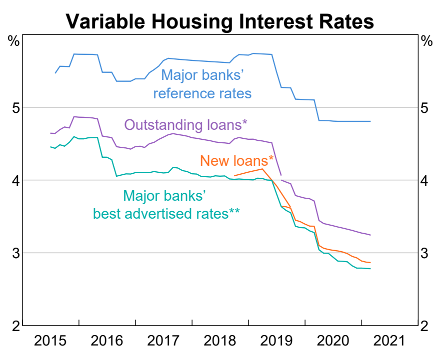
Interest rates on new fixed-rate loans have declined by around 90 basis points since February 2020, to be around 60-75 basis points below new variable interest rates at the end of March 2021 (Graph 3.27). Accordingly, the proportion of new loans funded at fixed interest rates remains high by historical standards, and the stock of fixed-rate housing loans has risen to around 30 per cent of housing credit outstanding, up from 20 per cent at the start of 2020.

The share of fixed-rate loans funded with maturities of longer than 3 years has risen in recent months, as banks offered increasingly attractive interest rates for these loans following the further easing of monetary policy in November 2020. While advertised rates on 4-year and 5-year fixed-rate loans have increased slightly at some banks since mid March, alongside a rise in longer-term fixed interest rates derived from swap rates (the benchmark for pricing fixed-rate loans), on average these rates are still around historic lows. At the same time, some banks have lowered advertised rates on 1-, 2- and 3-year fixed-rate loans further since mid March.

Interest rates on business loans also continued to decline gradually

After declining substantially in early 2020, following the Reserve Bank's initial package of policy measures, interest rates on outstanding

Graph 3.26



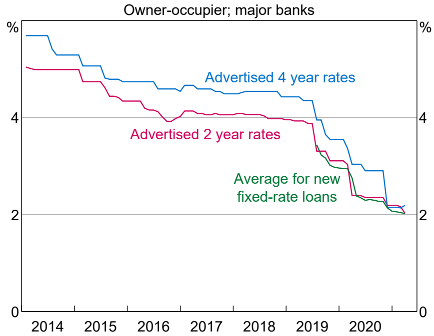
* Series break in July 2019; thereafter, data based on EFS collection
** Including low-cost brands
Sources: APRA; banks' websites; CANSTAR; RBA; Securitisation System

business loans have continued to drift down. Interest rates on variable-rate loans to SMEs and large businesses have declined by around 90 basis points since the end of February 2020, while interest rates on fixed-rate loans to SMEs and large businesses have declined by around 60 and 50 basis points, respectively (Graph 3.28). The recent declines in outstanding small business lending rates have largely been for fixed-rate loans. Since the start of 2021, several banks have announced reductions in interest rates for small business loans of between 10 and 80 basis points, mostly for loan products that have fixed interest rates.

Graph 3.27

Fixed Housing Rates

Owner-occupier; major banks

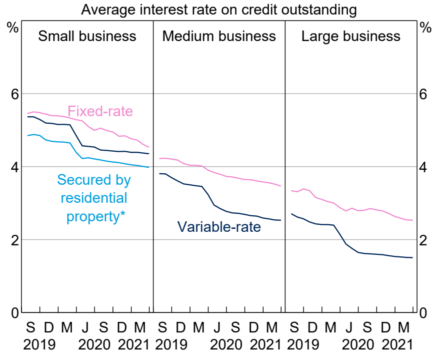


Sources: APRA; banks' websites; RBA

Graph 3.28

Business Lending Rates

Average interest rate on credit outstanding



* Small business loans secured by residential property can have fixed or variable interest rate terms and are included in the fixed-rate and variable-rate lines

Sources: APRA; RBA

Growth in total credit has increased over recent months

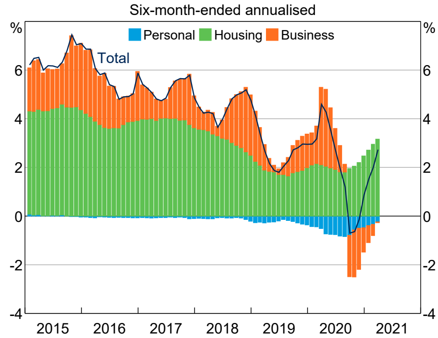
In recent months, credit growth has picked up to be around its rate prior to the pandemic. Total credit growth increased in the March quarter to be 2¾ per cent in six-month-ended-annualised terms (Graph 3.29; Table 3.2). The increase has been driven by a pick-up in housing credit, particularly to owner-occupiers. Demand for housing credit is being supported by low interest rates and government policy measures targeted at first home buyers. The HomeBuilder scheme, which was closed to new applications at the end of March, has also contributed. Business credit outstanding has increased a little in recent months, after the sharp run-up and subsequent unwind in 2020. The weak demand for business credit overall is consistent with many businesses still having little need for external funding given the large cash buffers businesses have accumulated over the past year.

The pace of decline in personal credit has eased in recent months. Much of this reflects an increase in spending on credit cards alongside the recovery in economic conditions as restrictions to contain the virus were eased.

Graph 3.29

Contribution to Total Credit Growth*

Six-month-ended annualised



* Seasonally adjusted and break-adjusted

Sources: APRA; RBA

Table 3.2: Growth in Financial Aggregates

Percentage change[a][b]

	Three-month annualised		Six-month annualised	
	Dec 2020	Mar 2021	Sep 2020	Mar 2021
Total credit	2.0	3.4	–0.7	2.7
– Household	3.6	5.0	1.5	4.3
– Housing	4.5	5.6	3.1	5.1
– Owner-occupier	6.3	7.5	5.3	6.9
– Investor	1.1	2.2	–0.5	1.6
– Personal	–6.2	–3.7	–16.1	–5.0
– Business	–1.0	0.8	–5.1	–0.1
Broad money	8.4	3.2	13.5	5.8

(a) Seasonally-adjusted and break-adjusted

(b) Sources: ABS; APRA; RBA

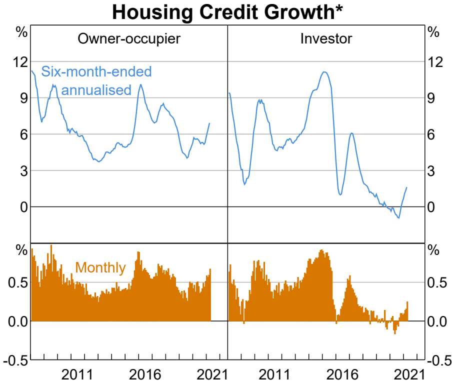
Demand for housing loans remains strong

Housing credit growth strengthened further in the March quarter to be around 5 per cent on a six-month-ended-annualised basis. Loans to owner-occupiers have mostly driven the increase, but investor housing credit has also increased following a period of small declines (Graph 3.30).

Commitments for new housing loans remain elevated following a period of very strong growth (Graph 3.31). The strong demand for housing loans from owner-occupiers in part reflects continued strength in demand from first home buyers. The modest pick-up in demand for investor loans has occurred alongside the improved outlook for housing prices. Even so, investor credit growth remains low by historic standards and there are a number of factors that may weigh on investor activity in the period ahead, including lower rental yields, high vacancy rates in some areas and lower immigration.

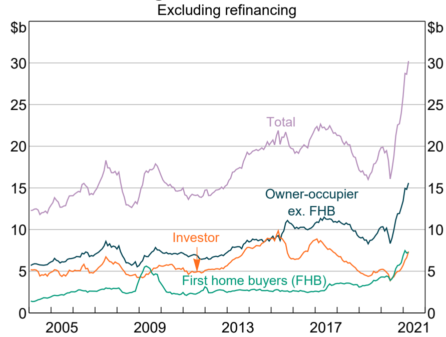
Construction loan commitments – which picked up strongly following the announcement of the

Graph 3.30



* Seasonally adjusted and break-adjusted
Sources: APRA; RBA

Graph 3.31



* Seasonally adjusted and break-adjusted
Sources: ABS; RBA

HomeBuilder program in mid 2020 – will continue to provide some support to housing credit growth over the coming months (Graph 3.32). Borrowers draw down on these loans over the period of construction, so the loan amount is recorded as housing credit incrementally and over that time. This differs from other housing loans, where the full loan amount is drawn down at settlement and is recorded as housing credit at that time. The government recently announced that borrowers have an additional 12 months to commence construction under these loans (now 18 months in total). The HomeBuilder program, which was closed to new applications at the end of March, is likely to have brought forward some demand, so the end of the program is expected to dampen demand for new construction loans for a time.

The availability of housing credit had tightened a little in response to the pandemic. However, banks have since eased some criteria by reducing requirements for additional information and lowering discounts applied to highly variable sources of income (such as bonuses and commissions) when assessing a borrower's capacity to service a loan.

Overall, the major banks' market share of housing lending has decreased since 2017, while the shares of other Australian banks and non-bank lenders have increased (Graph 3.33). While non-major bank lenders have gained most market share since then, non-bank lenders' market share has surpassed its recent peak of mid 2020. The recent increase in non-bank market share is consistent with the narrowing of the spread between lending rates of non-banks and banks since mid 2020.

Payments into housing loan offset and redraw accounts remain higher than prior to the pandemic

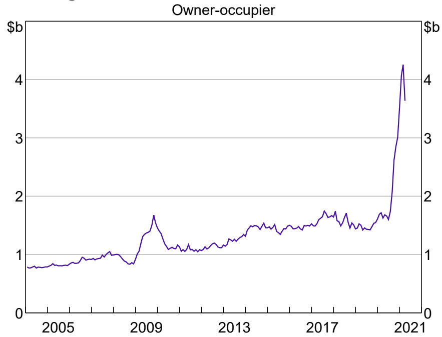
Net payments into offset and redraw accounts remained high in the March quarter. Over the past year, mortgage borrowers have made substantial payments into offset and redraw accounts, amounting to 4 per cent of disposable income (around $55 billion) (Graph 3.34). Payments have eased a little since their peak in mid 2020, consistent with the continued recovery in consumption, a tapering in fiscal payments and a decline in the number of households that accessed early release superannuation leading up to the closure of that option at the end of 2020.

Over the past year, reductions in housing loan interest rates have flowed through to borrowers in the form of lower interest payments (Graph 3.35). Since March 2020, interest payments have declined by around

Graph 3.32

Housing Loan Commitments for Construction*

Owner-occupier



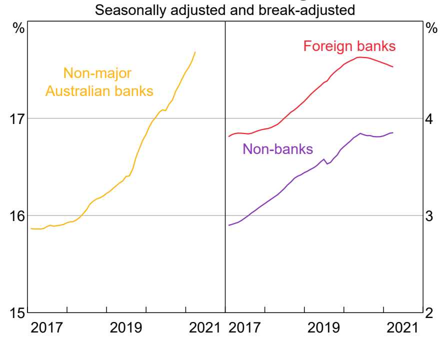
* Seasonally adjusted and break-adjusted

Sources: ABS; RBA

Graph 3.33

Market Share of Housing Credit*

Seasonally adjusted and break-adjusted



* Remaining share consists of major banks

Sources: APRA; RBA

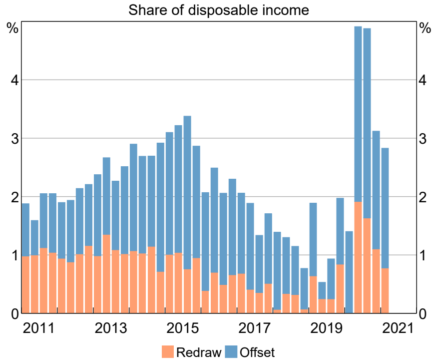
¾ percentage point as a share of disposable income, notwithstanding the rise in housing credit over that period. This reflects the pass-through of the Bank's policy easing and borrowers refinancing to lower interest rates, as well as the strong growth in disposable income since that time.

Repayment deferral arrangements concluded at the end of March, with almost all borrowers having now resumed repayments. The share of mortgage holders with a deferral in place has declined from a peak of around 8 per cent at the end of June 2020 to less than ¼ per cent at the end of March 2021; of those, most have had

Graph 3.34

Flows into Offset and Redraw Accounts*

Share of disposable income



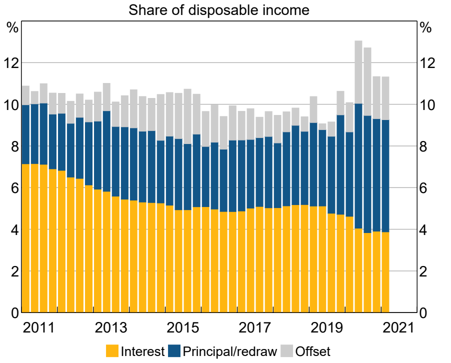
* Seasonally adjusted and break-adjusted

Sources: ABS; APRA; RBA

Graph 3.35

Flows into Housing Loan and Offset Accounts*

Share of disposable income



* Seasonally adjusted and break-adjusted

Sources: ABS; APRA; RBA

their deferral extended. A small share of loans that have exited deferral – just 3 per cent – are non performing.

Business lending has increased a little over recent months

Lending to businesses has increased a little over the past few months, consistent with an improvement in overall business sentiment, after having decreased over much of the second half of 2020. Lending to large businesses has increased a little following its run-up and subsequent unwind in 2020 as the lines of credit that were drawn on early in the pandemic were repaid. Lending to SMEs has remained little changed throughout this period, as it has for some years. Commitments for new business loans have also been steady over recent months.

Liaison with banks suggests there has been a bit more appetite for business borrowing of late given the improved economic outlook. However, many businesses still have little immediate need for borrowing. Improved business operating conditions and policy support have allowed many businesses to maintain much of the large cash buffers that they accumulated in 2020 (see RBA (2021), Financial Stability Review, April). These large buffers have limited the need for many businesses to seek additional finance. Consistent with this, surveys conducted by the ABS between late 2020 and early 2021 have indicated that only a small share of businesses have attempted to access additional funds, with most businesses responding they have sufficient funds at hand.

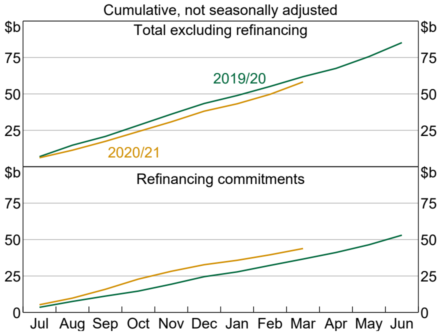
The total volume of new loan commitments extended to SMEs over the financial year to date has been a little lower than over the comparable period of the year prior (Graph 3.36). However, there have been some pockets of increased activity within overall SME lending. Lending to the agriculture sector remained elevated due to favourable weather conditions over the past year or so, and lending activity for plant and equipment has been supported by the Australian Government's enhancements to the instant asset tax write-off scheme. Meanwhile, SME refinancing activity has been higher so far in the 2020/21 financial year compared with the year prior, which suggests that some businesses have been refinancing to the lower interest rates on offer.

Take-up of the Australian Government's $40 billion SME loan guarantee scheme, which started in late March 2020 and was enhanced in October 2020, has been modest to date. About $4 billion of loan commitments have been made to around 40,000 businesses under the scheme. In April, the government introduced the SME Recovery Loan Scheme, which is an enhanced and extended loan guarantee scheme for SMEs that had received JobKeeper payments in the March quarter 2021. Under the scheme, those SMEs with annual turnover up to $250 million (previously capped at $50 million) can now borrow as much as $5 million (up from $1 million previously) for up to 10 years (up from 5 years previously). In addition, the funds borrowed can be used to refinance existing loans (refinancing was not permissible previously), and the Government is increasing the guarantee to 80 per cent (up from 50 per cent). The new scheme will be accessible until the end of 2021. Other businesses eligible for the original scheme can still access funds until the end of June 2021 based on the terms announced in October 2020. Some banks have started advertising loan products under the new scheme, with interest rates generally lower than comparable products under the original scheme.

Graph 3.36

SME New Loan Commitments

Cumulative, not seasonally adjusted



Sources: APRA; RBA

Repayment deferral arrangements for small business borrowers concluded at the end of March. Most of the over 200,000 SME borrowers that had arranged loan payment deferrals in 2020 have now resumed repayments. At the end of March 2021, only a very small share of SME borrowers (less than ¼ per cent) had a deferral arrangement in place (down from a peak of around 13 per cent at the end of June 2020) with those remaining made up of borrowers who have had their deferral extended.

The supply of business credit has improved a little, but credit remains hard to access for small businesses

Some banks have indicated that they are seeking more opportunities to lend to businesses, including smaller businesses, in part reflecting the improved economic outlook. Consistent with this, surveys of small businesses indicate that access to finance became less difficult towards the end of 2020, after tightening following the onset of the pandemic. However, banks remain cautious about the industries still most adversely affected by the pandemic.

Australian equity prices have increased

The ASX 200 has increased further over recent months to be around 3 per cent higher than its February 2020 peak on a total return basis, which takes dividends into account. The rebound in global equity prices since March last year reflects the recovery in the global economic outlook, supported by fiscal and monetary stimulus, and as effective COVID-19 vaccines have been developed and administered

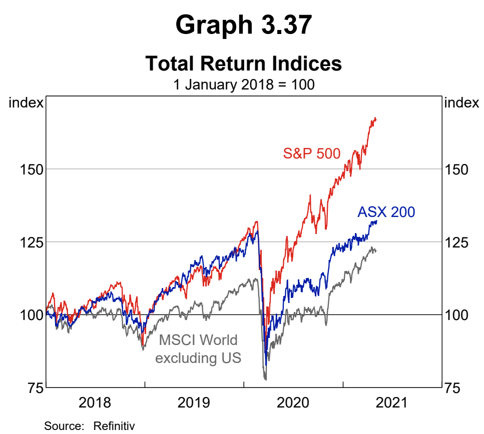
(Graph 3.37). Since the end of 2020, the ASX 200 has underperformed overseas equity markets, which have been well above their pre-pandemic peaks for some time on a total return basis.

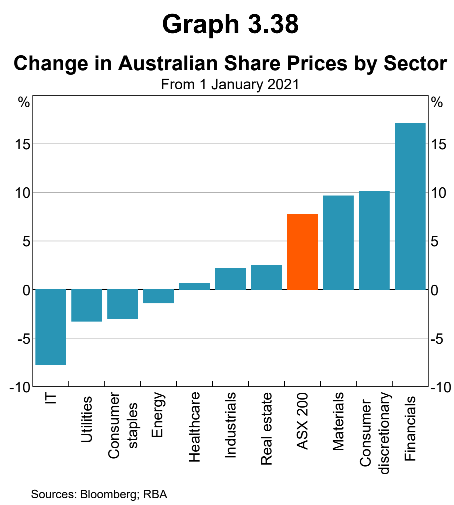
Since the beginning of 2021, financial and consumer discretionary stocks have posted the largest gains, increasing by about 17 and 10 per cent, respectively (Graph 3.38). By contrast, the prices of consumer staples, information technology and healthcare stocks have underperformed the market this year, after seeing large gains throughout 2020. Sectors that tend to be viewed as somewhat substitutable for bonds, like utilities and real estate, have underperformed the broader market alongside the increase in longer-term bond yields since late February.

Profits of listed companies are generally lower than a year ago, but substantially higher than 6 months ago

Aggregate underlying profits of ASX 200 companies were 21 per cent lower in the December half of 2020 compared with the same period a year earlier (Graph 3.39). The decline reflected substantially lower earnings across firms in the financial, industrials, utilities and real estate sectors. A number of materials companies recorded higher underlying earnings, benefiting from elevated iron ore prices. By contrast, the energy sector recorded a decline in earnings on the back of lower demand for oil and LNG. In general, listed company profits in the December half of 2020 were substantially higher than in the June half, as a result of the recovery in economic activity. Overall, results were above analysts' expectations, with earnings having recovered more strongly than expected after the heavily pandemic-affected June 2020 half. More recently, some financial companies have reported higher profits for the 6 months to March 2021, in line with the continued recovery in economic activity.

At an aggregate level, total dividends announced to be paid in the June half of 2021 increased relative to the December half of 2020, to be similar to the level of a year ago (Graph 3.40). The increase in dividends was driven by a large rise in dividends from mining firms, while dividends from outside the energy and materials sector are lower than one year ago. The dividend payout ratio for energy and materials companies increased marginally compared with the December 2020 half. The payout ratio for all other sectors declined substantially, as dividends increased by much less than underlying earnings. Share buybacks, which tend to be much smaller than dividends,





remained low throughout 2020 compared with recent years.

The assets of Australian listed non-financial corporations decreased by 5 per cent over the December half of 2020. Aggregate gearing ratios declined, predominantly reflecting a decrease in debt levels, consistent with the repayment of lines of credit drawn down in the early stages of the pandemic (Graph 3.41). The decrease in gearing was most pronounced in the consumer staples, consumer discretionary and healthcare sectors, after increasing in prior years. Net gearing in the materials, industrials and utilities sectors decreased marginally while real estate sector gearing was little changed, remaining at a low level relative to the past 2 decades.

The Australian dollar remains within its range since the start of the year

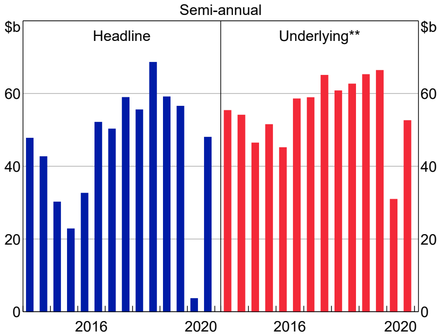
The Australian dollar has depreciated a bit from its highs in late February, but is a little above its levels observed earlier in the year on both a trade-weighted basis and against the US dollar (Graph 3.42). This follows the period since November when commodity prices increased markedly, to their highest levels in a number of years, and the Australian dollar appreciated against most currencies. The prices of a number of Australia's key commodity exports have continued to be supported by the recovery in global trade and strength in Chinese steel production this year (see 'The International Environment' chapter).

The differential between shorter-term interest rates on Australian government bond yields and those of the major advanced economies has been little changed over recent months, and the differential between longer-term interest rates has declined from its highs in late February. The lower structure of interest rates in the domestic economy associated with the Bank's policy measures over the past year or so has

Graph 3.39

ASX 200 Profits*

Semi-annual



* Latest data are based on a matched sample of companies that have reported so far in the latest half. Results for companies with reporting dates in the half are rolled forward

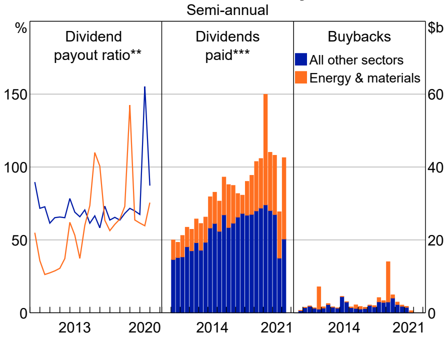
** Underlying results adjust for one-off items such as asset revaluations.

Sources: Bloomberg; Company reports; Morningstar; RBA

Graph 3.40

ASX Dividends and Buybacks*

Semi-annual



* Dividend payout ratio and dividends are for ASX 200 companies; buybacks are for ASX-listed firms

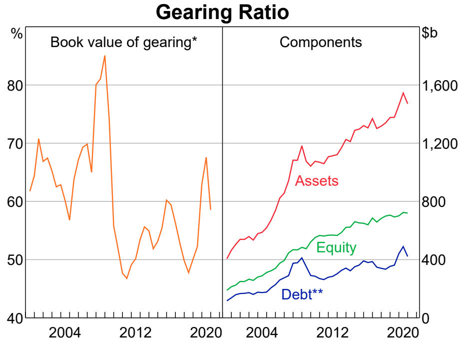
** Dividends paid as a percentage of underlying profits

*** Last observation is dividends announced

Sources: Bloomberg; Company Reports; Morningstar; RBA

Graph 3.41

Listed Non-financial Corporations' Gearing Ratio



* 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

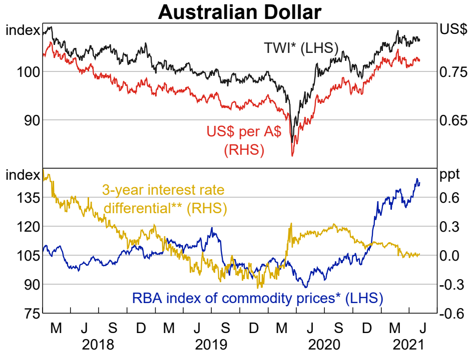
Sources: Company reports; Morningstar; RBA contributed to the exchange rate being lower than otherwise. The level of the Australian dollar is broadly consistent with its fundamental determinants – namely the terms of trade and the differential between interest rates in Australia and those in major advanced economies.[2]

Australia experienced a net outflow of capital in 2020

Australia was a net lender of capital in 2020 with capital outflows exceeding capital inflows. This is the corollary of Australia's current account surplus (see 'Domestic Economic Conditions' chapter). Net outflows have mainly been associated with the decline in the outstanding stock of debt issued abroad by Australian banks, which has partly reflected access to low-cost funding domestically, including through the TFF, as well as slower credit growth (Graph 3.43). These outflows were partly offset by inflows related to foreign purchases of Australian government debt. Equity outflows exceeded inflows in 2020, reflecting superannuation and investment firms purchasing foreign equities in the second half of the year.

Graph 3.42

Australian Dollar



* Indexed to 1 January 2020 = 100

** Spread to the United States, Japan and Germany, weighted by GDP. Includes yields on the April 2024 Australian Treasury bond

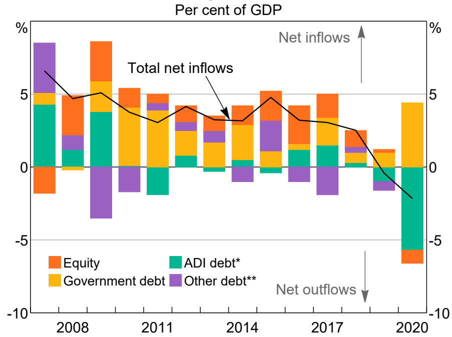
Sources: Bloomberg; RBA

Australia's net foreign liability position remains lower than in previous years as a per cent of GDP. Over recent years, movements in the net foreign liability position have been largely driven by an increase in the value of Australia's foreign equity asset position (Graph 3.44). The net income deficit, which is comprised of payments and receipts made on the net foreign liability position, has narrowed to its lowest level as a per cent of GDP since the 1970s. This narrowing reflects a decrease in payments, including dividends and interest payments, on Australia's foreign liabilities compared with income from Australia's foreign assets.

Graph 3.43

Net Capital Flows

Per cent of GDP



* Adjusted for the US dollar swap facility in 2008-09 & 2020

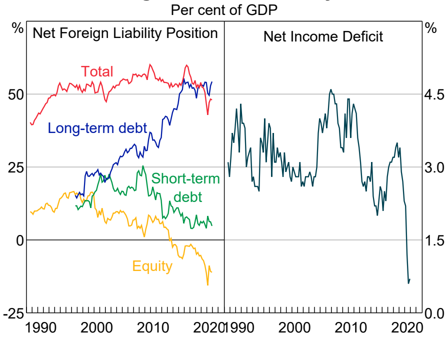
** Includes public corporations and private sector

Sources: ABS; RBA

Graph 3.44

Net Foreign Position and Payments

Per cent of GDP



Sources: ABS; RBA

Endnotes

[1] See Alston M, S Black, B Jackman and C Schwartz (2020), 'The Term Funding Facility', RBA *Bulletin*, December, viewed 28 January 2021. Available at <https://www.rba.gov.au/publications/bulletin/2020/dec/the-term-funding-facility.html>

[2] For more information about the determinants of the Australian dollar over recent years, see Atkin T, I Hartstein and J Jaaskela (2020), 'Determinants of the Australian Dollar Over Recent Years', RBA Bulletin, viewed 5 May 2021. Available at <https://www.rba.gov.au/publications/bulletin/2021/mar/determinants-of-the-australian-dollar-over-recent-years.html>