Overview

Financial market compensation for risk remains low despite the greater chance of weak global growth

Uncertainty about the outlook for global economic growth has increased since the previous *Financial Stability Review*, with a greater chance of weak growth. The US–China trade and technology disputes have seen forward-looking indicators for trade and investment decline. Spillovers from an escalation of tensions in Hong Kong or the Middle East or a disorderly Brexit could also trigger a slowdown. In light of the increased risks to economic growth, the US Federal Reserve, the European Central Bank and some other central banks have eased monetary policy and financial markets expect further easing. This has led to lower government bond yields. However, higher uncertainty has not resulted in investors demanding increased compensation to bear risk. Estimates of term premiums, and credit and liquidity risk premiums, are low and some have declined further. These lower risk-free interest rates and low risk premiums have seen many asset prices rise further from already high levels. The apparent confidence embodied in financial market pricing belies the more uncertain growth outlook and vulnerabilities in the financial system, including the high level of debt in some sectors and concerns about the resilience of banks in a few economies.

In Australia, yields have fallen substantially with asset prices rising further

Domestically, government bond yields have fallen by more than international yields this year as the expected path of the cash rate has declined. The cash rate has been cut by 75 basis points since May, and financial markets expect further easing will be needed to achieve the Bank's inflation and employment objectives. Domestic risk premiums are also generally at low levels. As in other economies, lower risk-free interest rates in Australia have underpinned rising prices of many assets.

The cuts to the cash rate, and the resulting reductions in borrowing rates, have contributed to a turnaround in some established housing markets. Housing prices have risen in Sydney and Melbourne in the past few months after falling for around 18 months, and there are some tentative signs that turnover may be near its trough. However, in Western Australia and the Northern Territory, housing prices have continued their prolonged decline. Conditions in other housing markets are generally subdued.

A search for yield, low borrowing costs and strong fundamentals have underpinned commercial property valuations, particularly in Sydney and Melbourne. Strong demand for offices is easily meeting the increase in supply for now, and valuations have continued to rise as yields look attractive in a low interest rate environment. In contrast, weak conditions and changes in market structure in retailing have resulted in difficult conditions for some types of retail property. However, banks' commercial

property exposures are a fairly small share of their assets.

Despite slower economic growth domestically, businesses' profitability has remained around its historical average. This has enabled most businesses to easily make their debt repayments. While gearing has increased a little, it is not high relative to historical levels and debt servicing costs are low given the level of interest rates. However, some businesses, such as discretionary retailers, small businesses, some construction firms and those affected by the drought, are confronting challenging conditions.

There are (as always) some notable risks for financial stability in Australia

External shocks

A downturn in the global economy, asset price falls or reduced availability and increased cost of borrowing could be quickly transmitted to Australia through trade and financial links. A sharp decline in global economic activity would likely see asset prices fall, as well as reduce Australia's exports and domestic activity. But the impact on Australia would depend on the exact nature of the external shock and movements in the exchange rate. Australia's exports to China are disproportionately used in the Chinese domestic economy rather than as inputs for the production of Chinese exports. Australia's exports may therefore decline by proportionately less than global trade in response to an escalation of trade disputes, if Chinese domestic growth is maintained. But a more generalised slowdown in China could have a larger impact on domestic growth and hence the financial system.

In the current environment, there are many possible triggers for dislocation in financial markets. One is a sharp increase in risk premiums, and therefore longer-term interest rates, from their current historically low levels. In recent years, inflation has been lower than past relationships with labour outcomes would predict. But if historical inflation dynamics did re-emerge, particularly in economies with very low unemployment, it could surprise markets and spur a re-evaluation of risk premiums and the path of central bank policy rates. Other asset prices would likely fall alongside bond prices, causing widespread losses in wealth, which could be particularly problematic for asset holders with high leverage.

High household debt

Household debt in Australia is around 190 per cent of household income, which is higher than in most other countries. Internationally, high household debt was a significant amplifier of economic and financial shocks in the financial crisis a decade ago, including through the effects on household consumption. In Australia, housing debt is generally well collateralised. Furthermore, around three-quarters of the debt is owed by households in the top 40 per cent of the income distribution, who generally have a high capacity to make repayments and are less likely to experience sustained unemployment. These factors reduce the potential losses for lenders. Most households are comfortably making their current debt repayments, with the arrears rate low both by international standards and in absolute terms. But the rise in housing non-performing loans to its highest level in several years is notable. Rising unemployment or ongoing weakness in income growth would likely see an increasing share of households struggle to make their debt repayments.

While the potential for direct losses to the banking system from high household debt seems limited, highly indebted households could curtail their consumption if there was a significant increase in job insecurity. With around one-third of households having mortgage debt, in aggregate this could result in a sizeable decline in consumption and so

amplify any shock to the economy and so the financial system.

Risks in housing markets

In the near term, risks from falls in housing prices have reduced but still exist. The uptick in housing demand and prices in Sydney and Melbourne has reduced the risk that sustained falls in housing prices could lead to widespread negative equity and so potential losses for lenders. However, the rental vacancy rate in Sydney is relatively high and a possible oversupply of apartments in some areas in Sydney could see prices and rents fall in some locations. Further, prices are still falling in Western Australia and the Northern Territory, and the incidence of negative equity is rising. A further 10 per cent fall in prices in these regions would see over one-third of these loan balances being associated with negative equity. For the country as a whole, the incidence of negative equity remains low and the vast majority of borrowers in negative equity are making their repayments on schedule.

Further out, there are potential risks from a resurgence in rapid housing price growth. The fall in housing demand and prices over the past couple of years, particularly in Sydney and Melbourne, as well as tighter credit supply for developers, has resulted in residential building approvals falling sharply. With population growth projected to remain strong, ongoing weakness in buildings approvals would likely result in a shortage of new housing in several years' time with a resulting risk of rapid growth in prices that would stimulate stronger debt growth.

Banks' non-financial risks

Banks face challenges resulting from their many legacy IT systems and the ever-present threat of cyber attacks. Attacks designed to disrupt the broad financial system could be spread across banks or target common systems or key financial market infrastructure. Banks need to devote close attention to these risks while also managing large changes in their operations. These changes to their operations have resulted from the recommendations of several inquiries over the past couple of years, including the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Despite these risks, the financial system is generally resilient

The resilience of the Australian financial system has steadily improved as a result of actions taken in response to the lessons learned from the financial crisis. Major post-financial crisis international reforms have been implemented in Australia, requiring banks to hold more capital and liquid assets. On an internationally comparable basis, Australian banks' Tier 1 capital ratios are likely well within the top quartile of equivalent banks, and comfortably inside the range needed to withstand the magnitude of shocks associated with most historical banking crises internationally. The implementation of the framework for loss-absorbing capacity (LAC) announced by APRA will further improve the resilience of the financial system. The tightening in lending standards for residential mortgages in recent years has appropriately improved the quality of new lending. However, it is important that banks are not overly cautious in the implementation of current lending policies. Lending always entails a degree of risk but excessive risk aversion by financial institutions can curtail the provision of credit that facilitates economic growth. It is crucial that the financial system is highly resilient, and so can continue to support economic activity, even if there are severe economic and financial shocks.