1. Financial Conditions

Summary

- **Monetary policy settings in advanced economies are restrictive**, but broader measures of financial market conditions have eased over recent months, in response to a number of signs that labour markets are becoming less tight and that inflation continues to moderate.
- **Market participants have brought forward the timing of when they expect central banks to begin cutting policy rates, although fewer rate cuts are anticipated in Australia than in other peer economies.** Government bond yields have declined significantly from their peaks, and risk spreads have narrowed on market expectations that inflation can return to central banks' targets without significant downturns.
- **Advanced economy central banks have generally been more cautious in their own signalling, judging that more evidence is required to justify an easing of policy.** However, most have acknowledged that policy rates have probably peaked.
- **Overall financial conditions in Australia appear to be restrictive.** The tightening of monetary policy has led to a significant rise in household debt payments, households are reducing their rates of savings and household credit growth has moderated from the highs of 2022. At the same time, the value of the Australian dollar remains consistent with its key drivers and the flow of new lending to households has edged higher.

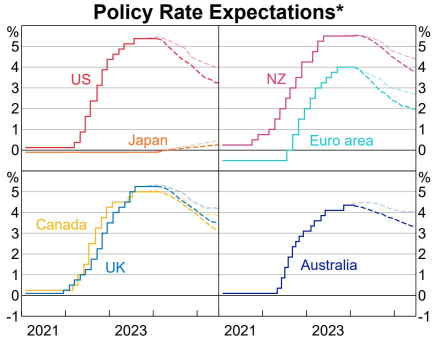
1.1 Interest rate markets

Many advanced economy central banks have signalled that policy rates are likely to have peaked amid a further moderation of inflation.

Most advanced economy central banks assess their policy rates to be restrictive and many, including the US Federal Reserve (Fed) and the European Central Bank (ECB), have also recently become more willing to discuss the possibility of reducing their policy rates in 2024. Indeed, the most recent rate projections from Fed policymakers imply a median projected decline of 75 basis points in the federal funds rate in 2024. The shift in assessment has occurred against a backdrop of continued progress on disinflation, a number of signs pointing to labour markets becoming less tight, and downward revisions to most advanced economy central banks' inflation projections. Market participants continue to expect a more rapid easing of policy than has been indicated by central banks (Graph 1.1).

Graph 1.1

Policy Rate Expectations*



* Darker dashed lines show expectations implied by current overnight indexed swap rates; lighter dashed lines show the same expectations as at the November SMP.

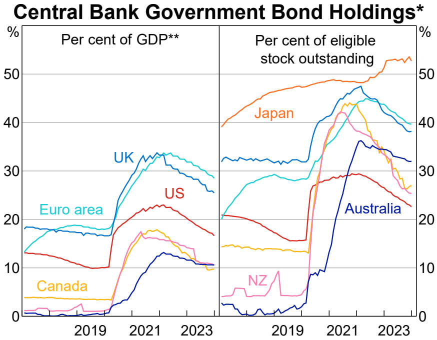
Sources: Bloomberg; RBA.

While advanced central banks are emphasising that policy rates are their active policy instrument, almost all continue to reduce the size of their balance sheets (Graph 1.2). In some cases, they have been signalling adjustments to the pace of decline. Fed officials have noted the option to slow the pace at which its balance sheet is declining to support an orderly transition to the desired steady-state level of reserves. They have pointed to measures indicating that the decline in reserves to date, from the approach of only reinvesting some bonds as they mature, has not caused any shortage of aggregate system-wide liquidity, although there were some small, temporary increases in repo rates in late 2023. By contrast, the ECB has announced that it will speed up the decline in its asset holdings, to bring forward the adjustment of its balance sheet, by reducing reinvestment.

In Australia, there was little reaction to the release of the minutes of the December Reserve Bank Board meeting. These noted the Board's decision to continue reducing the RBA's holdings of government bonds through maturities while keeping the approach under active consideration. Bonds to the value of $38 billion will mature in 2024.

Graph 1.2

Central Bank Government Bond Holdings*



* Central government debt only, except the euro area. Holdings for euro area only include asset purchase programs; holdings for UK do not include financial stability purchases; other central banks include bonds held for operational or liquidity purposes.

** Four quarter rolling sum. Japan (not shown) is currently 98 per cent of GDP.

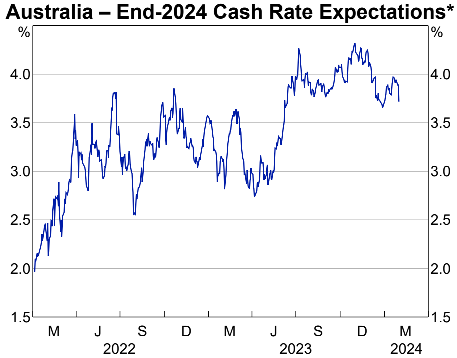
Sources: Central banks; debt management offices; LSEG; RBA.

Fewer cuts to the policy rate are expected in Australia than in many other advanced economies.

In Australia, market participants' expectations for the path of the cash rate as implied by overnight indexed swaps (OIS) have declined a little since late last year (Graph 1.3). Market-implied expectations for the cash rate declined following the December US Federal Open Market Committee meeting, but this was unwound as some advanced economy central bank officials pushed back against market expectations of near-term decreases in policy rates. More recently, OIS rates declined a little in response to lower-than-expected inflation data for Australia. Market pricing suggests that market participants believe the cash rate has reached its peak, with rate cuts of around 60 basis points priced in by the end of 2024. This is a little lower than the median forecast of market economists but broadly in line with market-implied forecasts for inflation to return to the target range during 2025. Compared with many other advanced economy central banks, both market pricing and economist forecasts suggest that the cash rate in Australia will peak at a lower level and begin to decline only later this year.

Graph 1.3

Australia – End-2024 Cash Rate Expectations*



* Daily; expectation implied by OIS.

Sources: Bloomberg; RBA.

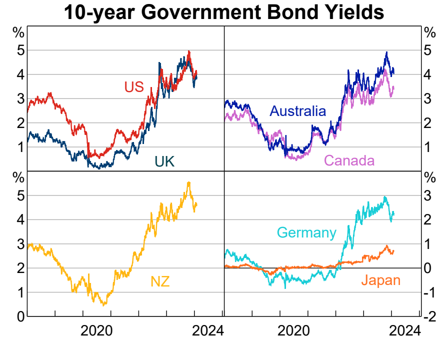
Government bond yields in advanced economies have declined over recent months, along with market expectations for significant reductions in policy rates amid larger-than-expected declines in inflation.

In many cases, the recent decline in yields reversed the increases that occurred between July and October, leaving the current levels of yields generally well above their post-global financial crisis (GFC) averages (Graph 1.4). The decline has been underpinned by falls in both real yields and inflation expectations (Graph 1.5). Longer term market-implied inflation expectations remain broadly consistent with central banks' inflation targets. Real yields have declined, which appears in part to reflect a decline in the real term premium, which is the yield on bonds over and above what is explained by expectations of inflation and future short-term real interest rates. This may reflect greater confidence that policy rates have peaked, speculation that the Fed may soon reduce the pace of quantitative tightening and an expected slowing in the pace of new government bond issuance. As usual, Australian Government Securities (AGS) yields have moved closely with those of major advanced economies.

Even so, the differential between AGS and US Treasury yields increased a little in recent months, particularly at the short end of the yield curve, reflecting a smaller decline in policy rate expectations in Australia compared with the United States (Graph 1.6).

Graph 1.4

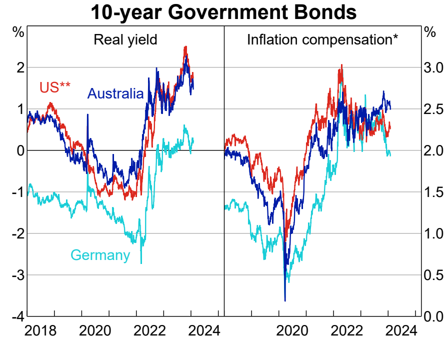
10-year Government Bond Yields



Source: Bloomberg.

Graph 1.5

10-year Government Bonds



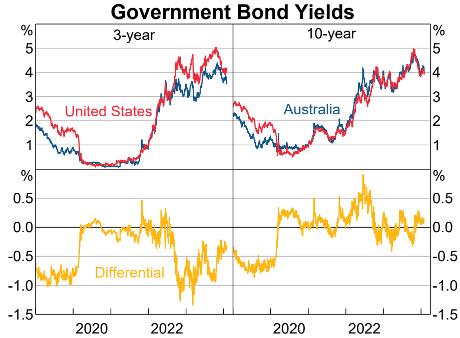
* Spread between yields on nominal and inflation-linked bonds.

** The price index referenced in US inflation-linked bonds has averaged 0.5 percentage points more than the index targeted by the US Federal Reserve over the longer term.

Sources: Bloomberg; RBA.

Graph 1.6

Government Bond Yields



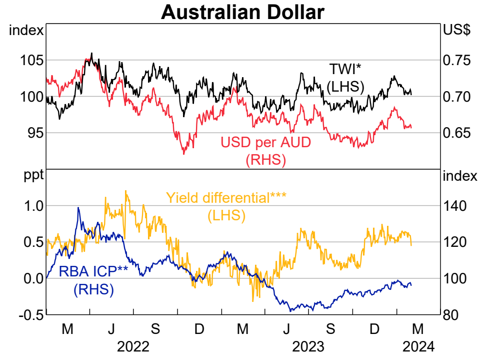
Sources: Bloomberg; RBA.

The Australian dollar is little changed overall.

The Australian dollar has appreciated slightly, both on a trade-weighted (TWI) basis and against the US dollar, since the November *Statement* (Graph 1.7). The appreciation has mostly reflected market expectations for a more rapid pace of policy easing in the United States than in Australia, relative to what had previously been anticipated. Indeed, the US dollar TWI has depreciated by around 1 per cent since early November. Riskier assets, which tend to be positively correlated with the Australian dollar, have rallied as markets have priced in additional policy easing in the United States. Meanwhile, there has been a modest increase in the RBA's Index of Commodity Prices (ICP), reflecting demand from China for iron ore and coking coal, and increases in LNG prices (see Chapter 2: Economic Conditions). The real Australian dollar TWI has remained in a relatively narrow range since the start of 2022 and is broadly consistent with model estimates implied by the forecast terms of trade and real yield differentials (Graph 1.8).

Graph 1.7

Australian Dollar



* Trade-weighted index; 31 December 2021 = 100.

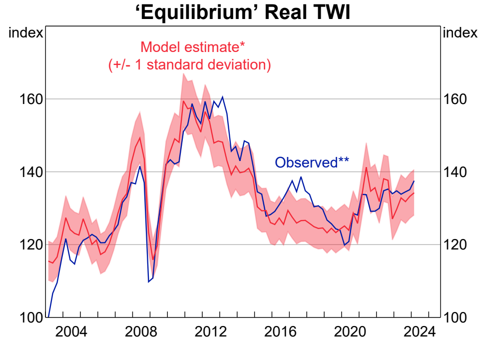
** Index of Commodity Prices (USD terms); 31 December 2021 = 100.

*** Three-year Australian sovereign yield less yields of the United States, Japan and Germany, weighted by GDP.

Sources: Bloomberg; RBA.

Graph 1.8

'Equilibrium' Real TWI



* Using terms of trade forecast and real Australian Government bond yield curve factors relative to the G3, see Chapman, Jääskelä and Smith (2018); standard deviation based on model errors.

** Indexed to March 2003 = 100; quarterly average real TWI.

Sources: Bloomberg; RBA.

1.2 Other measures of financial conditions

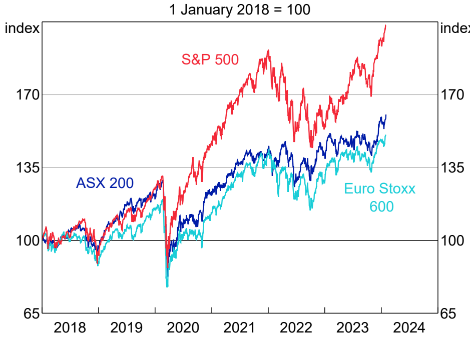
Some measures of private financial conditions have eased as markets appear increasingly confident that central banks can return inflation to target with minimal adverse effects on corporate profitability.

Equity prices in advanced economies have increased over the past two months, reaching record highs in the United States, Japan and Australia, and a little below record highs in Europe (Graph 1.9; Graph 1.10). The rise in equity prices is in part due to declines in bond yields, which increase the present value of future company earnings. Gains in equity prices are also likely to reflect increased market confidence that inflation can return to central bank targets with minimal adverse impact on future earnings. Similarly, spreads on corporate bonds in the United States, Europe and Australia have narrowed and are at their lowest levels since early 2022, consistent with market expectations of a relatively benign credit cycle (i.e. only a modest rise in company defaults) (Graph 1.11). The decline in spreads and risk-free rates has left corporate bond yields in the United States and Europe at their lowest levels in about a year, while they have been little changed for Australia over the same period.

Graph 1.9

Equity Prices*

1 January 2018 = 100



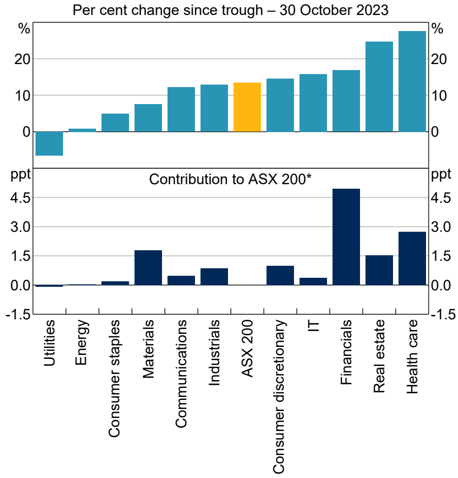
* Total return basis.

Sources: Bloomberg; LSEG.

Graph 1.10

Australian Equity Prices

Per cent change since trough – 30 October 2023



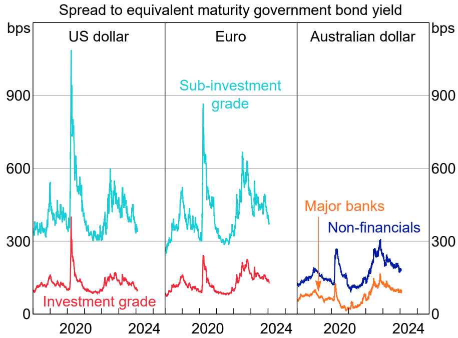
* Approximate measure based on current sectoral index weights.

Sources: Bloomberg; RBA.

Graph 1.11

Corporate Bond Spreads

Spread to equivalent maturity government bond yield



Sources: Bloomberg; ICE Data used with permission; RBA.

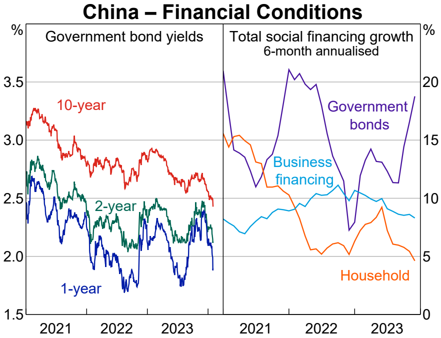
Overall issuance of corporate bonds in the United States and Europe has been lower than pre-pandemic averages of late, while it has remained strong in Australia. Bank credit growth remains positive in the United States and Europe but has fallen below pre-pandemic levels, particularly in Europe. Credit growth has also declined in Australia since 2022, but it has stabilised around its post-GFC average (see below).

Chinese financial conditions have eased a little alongside further policy support to address significant economic headwinds, including the considerable stress in the property sector.

Chinese Government bond yields have declined over recent months alongside some additional policy support and market expectations of a further easing of monetary policies (Graph 1.12). The People's Bank of China (PBC) lowered the required reserve ratio by 50 basis points and has encouraged banks to lend to priority sectors, such as manufacturing and affordable housing, through 'window guidance' and its Pledged Supplementary Lending facility (which is used by the PBC to provide long-term funding to policy banks in exchange for collateral). Additional funding has also been made available through the PBC's medium-term lending facility to assist banks to absorb a large increase in government bond issuance to support investment; in China, banks hold around 70 per cent of all government bonds (see Chapter 2: Economic Conditions). Overall, the scale of monetary policy easing to date has been moderate, with more substantive support being delivered through fiscal policy.

Graph 1.12

China – Financial Conditions



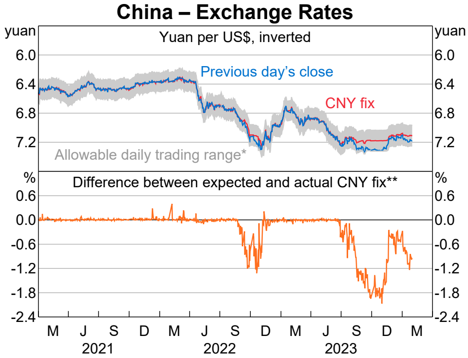
Sources: CEIC Data; RBA.

While the increase in government bond issuance has supported overall growth in total social financing, demand for credit by households and businesses has remained soft and household credit growth has declined further amid ongoing stress in the property sector. To provide further financial assistance to that sector, authorities have introduced additional measures to encourage banks to lend to the property sector, including the release of a 'whitelist' of projects deemed eligible for additional funding. Nevertheless, property developer asset prices have remained at severely distressed levels and ongoing challenges in meeting upcoming debt repayments have led many into extended negotiations with creditors. Evergrande (previously one of China's largest and most leveraged developers) was recently forced into liquidation by a Hong Kong court order after two years of negotiations with creditors. It is unclear the extent to which this will impinge on Evergrande's operations in mainland China. Stress in the property sector has largely been contained; however, there are some concerns about possible spillovers to other sectors. This includes local governments (which have historically relied on land sales revenue), trust companies, and small regional banks with weak capital positions and narrow profit margins that remain particularly exposed to stresses in the property sector.

The renminbi has appreciated modestly against the US dollar since the previous *Statement* alongside a narrowing interest rate differential between US and Chinese government bonds. Even so, the renminbi remains near its historical lows (Graph 1.13). A rise in bond investment inflows from foreign investors has more than offset further equity investment outflows that have contributed to a decline in equity prices to around levels last seen in early 2019. It has been reported that the authorities will allocate CNY2 trillion to fund mainland share purchases via offshore trading links to support equity prices and the renminbi.

Graph 1.13

China – Exchange Rates



* Since early 2014 the CNY has been allowed to trade in a daily range of +/- 2 per cent from the CNY fix.

** Negative value indicates official fix was stronger then expected by market economists, supporting the yuan against the US dollar.

Sources: Bloomberg; CEIC Data; RBA.

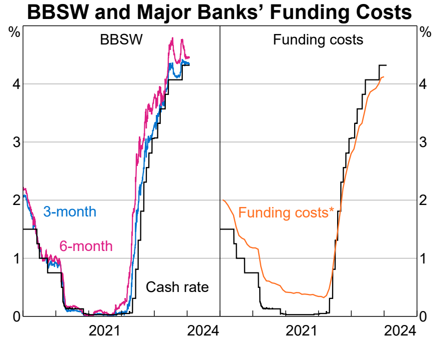
1.3 Australian banking and credit markets

November's cash rate increase has been passed through to bank funding costs, while financial institutions have been raising funding at favourable spreads in wholesale markets.

Banks' overall funding costs rose in recent months as the November cash rate increase was passed through to bank bill swap rates (BBSW) and deposit rates (Graph 1.14). Money market rates and the spread between BBSW and OIS rates have been little changed since the December Board meeting. If BBSW remain at current levels, bank funding costs are expected to plateau, suggesting that the direct impact of cash rate increases to date on bank funding costs has largely run its course.

Graph 1.14

BBSW and Major Banks' Funding Costs



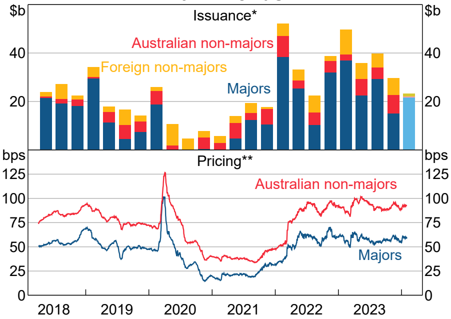
* RBA estimates of overall outstanding hedged debt and deposit costs for the major banks.

Sources: ABS; AFMA; APRA; ASX; Bloomberg; LSEG; major bank liaison; major banks' websites; RBA; Securitisation System; Tullett Prebon; US Federal Reserve.

Conditions in wholesale funding markets remain favourable for financial institutions. Bank bond issuance continues to be strong after reaching its highest level in over a decade in 2023. Strong issuance has occurred partly in response to large maturities in Term Funding Facility (TFF) funding over 2023 and forthcoming TFF maturities in the first half of 2024. The spread of bank bond yields to the swap rate – a reference rate for the pricing of fixed-income securities – has been little changed and remains around its average of the past two years (Graph 1.15). Banks generally swap fixed-rate payments on newly issued bonds into floating-rate payments to match their floating-rate loans, and so the spread to swap is an important component of bank wholesale funding costs. Issuance of asset-backed securities, by both banks and non-bank lenders, has also been strong in recent months, with 2023 recording the highest level of issuance since the GFC.

Graph 1.15

Bank Bonds



* Quarterly. Includes senior unsecured and covered issuance. March quarter 2024 observation is to 31 January.

** Spread to swap; domestic secondary market; three-year target tenor.

Sources: Bloomberg; Private Placement Monitor; RBA.

Higher interest rates have also been passed through to borrowers and depositors.

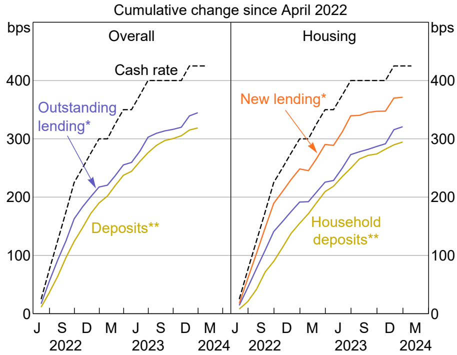
Australian households and businesses have seen substantial pass-through from increases in the cash rate to borrowing and deposit rates (Graph 1.16). Overall pass-through to borrowing and deposit rates has been substantial by international comparison, consistent with the prevalence of variable-rate mortgages in Australia. Nevertheless, both average outstanding mortgage interest rates and deposit rates have increased by less than the cash rate since May 2022. For mortgage rates, this is due to the high number of fixed-rate mortgages taken out at low rates during the pandemic as well as lenders competing for mortgage customers.

- Rates on outstanding **housing loans** have increased by around 105 basis points less than the 425 basis point increase in the cash rate over the hiking phase. Banks increased variable rates by a little less than 25 basis points in November following the cash rate increase. Competition for new and refinancing borrowers has eased since mid-2023, although banks have remained willing to offer discounts to retain existing customers. Pass-through to mortgage rates is expected to eventually reach similar proportions to previous hiking phases as the fixed-rate loans taken out at low rates during the pandemic expire.
- Rates on outstanding **business loans** have increased by around 35 basis points less than the cash rate over the hiking phase. Business rates have increased further since November, reflecting increases in three-month BBSW (ahead of the November cash rate increase) and the cash rate.
- The average rate paid on **deposit accounts** has increased by 105 basis points less than the cash rate over the hiking phase. The pass-through to deposit rates has been in line with the broad range of outcomes in previous hiking phases. Since May 2022, banks have increased rates on term deposits and conditional savings accounts by more than on other accounts. The Australian Competition and Consumer Commission's Retail Deposits Inquiry, concluded in December 2023, noted there had been limited pricing competition between banks, and that banks strategically set introductory and bonus interest rates on retail deposits to retain and attract customers.[1]

Graph 1.16

Change in Selected Bank Interest Rates

Cumulative change since April 2022



* Includes non-banks.

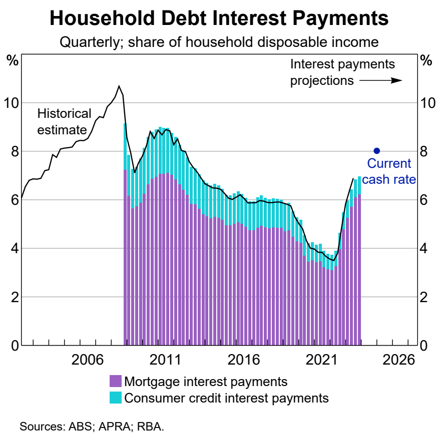
** Excludes deposits in housing loan offset accounts, includes non-interest bearing deposits.

Sources: APRA; RBA.

The tightening in monetary policy since 2022 has led to a significant rise in household debt payments, and households have been saving less of their incomes.

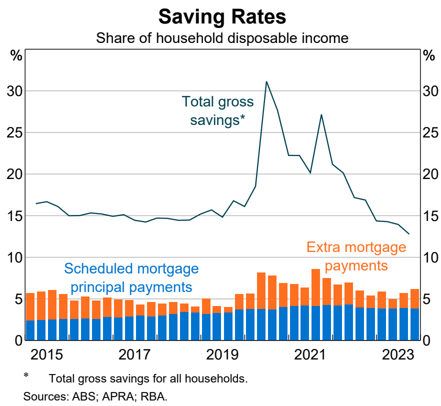
Interest payments on household debt – including both mortgage debt and consumer credit products – have increased by around 3¼ percentage points as a share of household disposable income over the tightening phase to around 7 per cent. These interest payments remain below their estimated historical peak as a share of total household disposable income, largely owing to a significant decline in the use of consumer credit since 2008. Even so, interest payments on household debt will increase further as expiring fixed-rate mortgages roll off onto higher rates and the November cash rate increase continues to flow through to mortgage payments. Based on the current cash rate, total interest payments are projected to increase to around 8 per cent of household disposable income by the end of 2024, which is slightly below the 2010–2011 peak when the cash rate reached 4.75 per cent (Graph 1.17).

Graph 1.17



Total scheduled payments (interest plus scheduled principal) for mortgages by themselves reached around 10 per cent of household disposable income in the December quarter, which is a record high. Although net payments into mortgage offset and redraw accounts have declined relative to 2020–2022, extra payments increased in the second half of last year to around the pre-pandemic average of 2 per cent of household disposable income (Graph 1.18). Both households with mortgages and households more generally have reduced their saving rates over the tightening phase to support consumption in response to cost-of-living pressures (see Chapter 2: Economic Conditions).

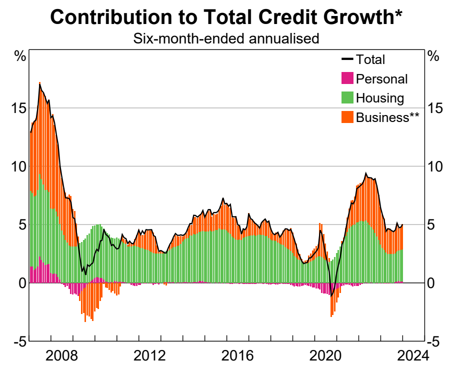
Graph 1.18



Total credit growth has stabilised at a lower level since mid-2023 in the face of higher interest rates, although new lending has picked up over the past year.

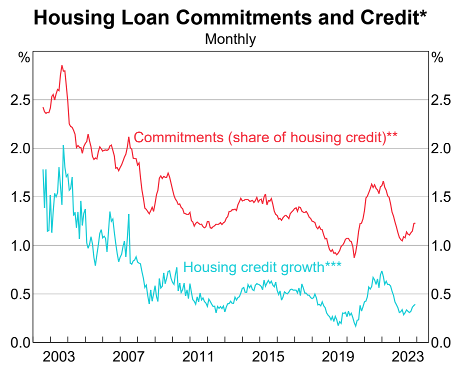
- **Housing credit growth is much lower than in early 2022, but it has edged up more recently.** It is likely to pick up a little further in the near term if the recent increase in new housing loan commitments is sustained (Graph 1.19). Housing loan commitments are around 20 per cent higher than their February 2023 trough, consistent with the rebound in national housing prices (Graph 1.20). The pick-up in housing loan commitments has been broadly based across states, with the increase most pronounced for investors and first home buyers.
- **Personal credit growth has picked up a little in recent months, driven by financing for vehicles** as disruptions to the supply of new cars have eased. The share of credit card balances accruing interest has remained low by historical standards, which suggests that most households are not making use of additional personal credit in response to cost-of-living pressures. Personal credit comprises less than 5 per cent of total credit.
- **Business credit growth has remained around its 20-year average**, supported by lending for purchases of vehicles and equipment. Corporate bond issuance (a source of funding for larger corporations) has been strong in recent months.

Graph 1.19



* Seasonally adjusted and break-adjusted.
** Excludes credit to the finance industry.
Sources: APRA; RBA.

Graph 1.20



* Seasonally adjusted and break-adjusted.
** Excludes refinancing.
*** Month-on-month growth.
Sources: ABS; APRA; RBA.

Endnote

[1] See ACCC (2023), 'Retail Deposits Inquiry 2023, Final Report', December.