3. Domestic Financial Conditions

Australian financial conditions have tightened as the Reserve Bank has taken steps in the normalisation of monetary conditions from the accommodative settings put in place to help insure the Australian economy against the worst possible effects of the COVID-19 pandemic. The Board has increased the cash rate target and the interest rate on Exchange Settlement (ES) balances by 175 basis points since early May, to 1.85 per cent and 1.75 per cent, respectively. This has occurred as other central banks in advanced economies have increased their policy rates relatively quickly and by more than earlier anticipated by financial market participants.

Australian Government bond yields have risen noticeably since late 2021. Bond yields have been quite volatile of late, in line with similar conditions in global bond markets. Yields increased sharply in June, on expectations of sharper monetary policy tightening in response to inflation, before retracing as market participants became concerned about an associated weakening in the outlook for global growth. Money market rates and yields at the short end of the yield curve have risen in recent months, reflecting the expected policy tightening in the period ahead. In Australia, current market pricing implies expectations of an increase of the cash rate to around 3 per cent by the end of 2022.

Banks' funding costs have risen considerably in recent months, reflecting the rise in market yields alongside increases in the cash rate. Lenders have passed on the cash rate increases up to July in full to reference rates for existing variable-rate housing borrowers and to most variable-rate business borrowers. Some lenders have also announced the full pass-through of the August increase in the cash rate to housing reference rates. Deposit rates have also increased, with term deposit rates rising at a faster pace and by more than rates on at-call deposits. Growth in credit has remained strong and demand for housing finance has remained high. However, commitments for housing loans have declined a little in recent months, consistent with the easing of activity in the housing market and increases in interest rates, actual and prospective. Business debt has grown strongly, driven by the borrowing of medium-sized and large firms.

The Australian dollar has appreciated of late, largely retracing the depreciation over the preceding months. These developments have occurred amid concerns about global growth and uncertainty about the outlook in China, which have also been reflected in lower commodity prices over recent months.

AGS yields have been volatile

Yields on Australian Government Securities (AGS) have traded in a relatively wide range in recent months, after rising considerably since late 2021 (Graph 3.1). Since the previous *Statement*, AGS yields have declined, having traded in a 125 basis point range and reached a peak in mid-June around levels last seen in 2014.

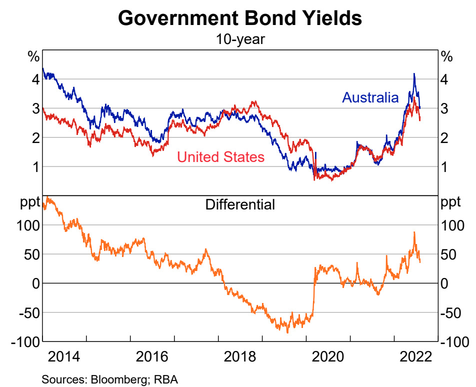
Long-term AGS yields have generally followed moves in yields in international markets over recent months (Graph 3.2). Yields rose further in June in response to larger-than-expected

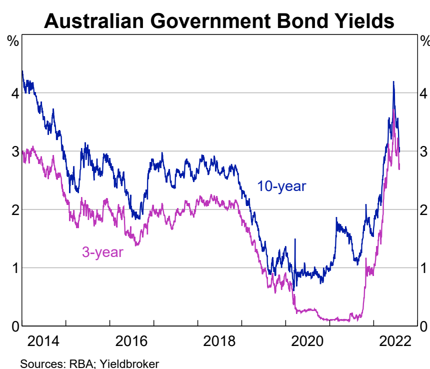
increases in inflation in advanced economies, which led to expectations that central banks would need to increase policy rates faster and to a higher level than previously anticipated. Since then, those increases have been retraced and yields are currently back around the levels seen in April, owing to concerns about a material slowdown in global growth. As is common in periods of higher volatility, AGS yields have moved by more than yields on US Treasuries; the spread between 10-year AGS and 10-year US Treasury yields widened to its highest level since 2014 alongside the increase in yields in June, before retracing lower as yields subsequently declined. In part, this reflects the effect of lower liquidity and a higher risk premium in AGS markets compared with US Treasury markets during periods when yields are moving around a lot.

Since late 2021, AGS yields have risen by more at the shorter end of the yield curve than at the longer end, reflecting increases in shorter term real yields and inflation compensation (which captures both inflation expectations and risk premia) (Graph 3.3). By contrast, the increase in longer-term AGS yields has been largely driven by higher real yields, while market measures of longer-term inflation expectations have remained anchored within the 2 to 3 per cent target range. This implies that market participants expect high inflation to be relatively short lived, which is generally the case across advanced economies.

AGS issuance has slowed a little

Bond issuance by the Australian Office of Financial Management (AOFM) has slowed somewhat, reflecting consistently stronger-than-expected government revenue in 2021/22 reducing the AOFM's funding task (Graph 3.4). Issuance by state and territory borrowing authorities has continued at a relatively steady pace in recent months. The spreads between semi-government securities (semis) and AGS yields rose markedly in May and June as volatility and thus risk premia increased, but have declined more recently.

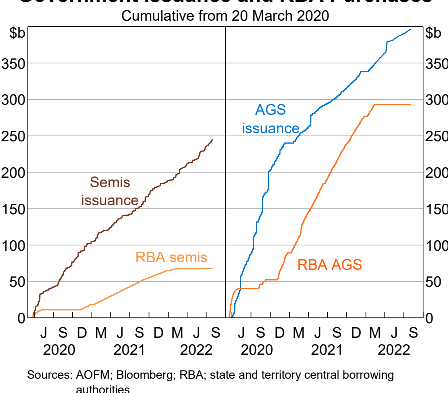




Most measures suggest bond markets continue to function reasonably well

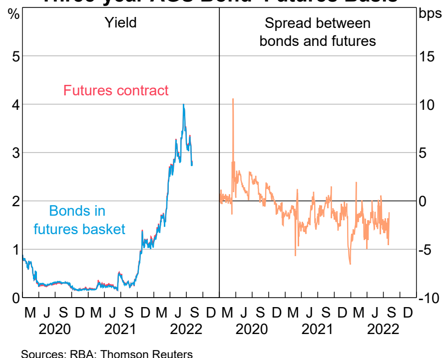
Bid-offer spreads for longer-term AGS and semis remain around their lowest levels in recent years, although they have widened a little following the increase in volatility in recent months. The implied yield on three-year bond futures contracts remained below the yield on three-year bonds over much of the past few months; arbitrage should keep this difference close to zero in an efficient market (Graph 3.5).

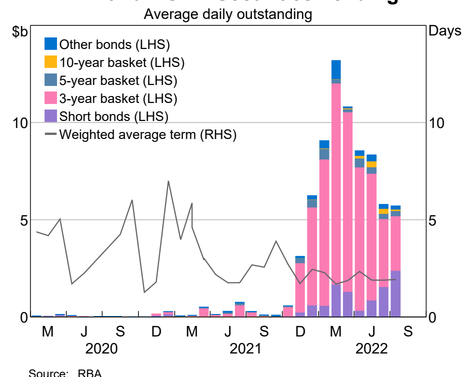
Demand to borrow AGS from the Bank has declined further from its recent peak of around $13 billion per day in February, following the end of the Bank's bond purchase program during that month and continued issuance by the AOFM (Graph 3.6). Borrowing still remains elevated, with an average of around $6 billion of bonds per day borrowed from the Bank's stock by market participants in July. Demand remains focused on bonds with residual maturities of two to three years, particularly those where the amount available in private markets is more limited because of the Bank's earlier purchases. Bond dealers borrow these bonds to help settle their own transactions and the transactions of their clients. By lending these bonds back into the market for short periods, the Bank is supporting the functioning of government bond markets.



Cash rate expectations have increased further

Market expectations for the cash rate have increased further in recent months, alongside expectations for higher inflation in the near term in Australia and globally, and further near-term policy rate rises in other advanced economies. Following the increase in the cash rate target to 1.85 per cent in early August, prices for overnight indexed swap (OIS) contracts imply that market participants expect further increases in the cash rate target over the remainder of the year. Market pricing implies that the cash rate is expected to reach around 3 per cent by December and a peak of around 3¼ per cent in





early 2023, consistent with the expectations of most market economists (Graph 3.7).

Transaction volumes in the cash market have picked up since earlier in the year and, as a result, the cash rate has been determined by market transactions on a majority of days since April. The cash rate has increased in line with the cash rate target since May, remaining 4 basis points below the target at 1.81 per cent in early August.

Money market rates have also increased further

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

Repurchase agreement (repo) rates at the Bank's regular open market liquidity operations (OMO) have increased further, with the OMO hurdle rate set at term-matched OIS plus a modest spread. This rate was 1.86 per cent at the OMO immediately following the August Board meeting. Demand for short-term liquidity obtained at OMO remains relatively low, but has increased a little in recent months.

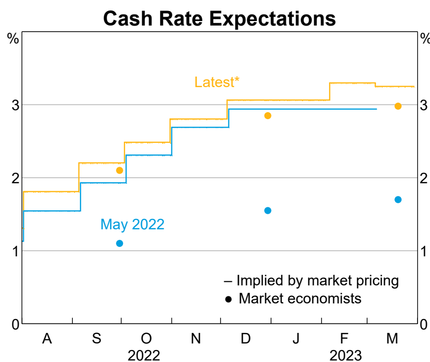
The Bank's balance sheet remains large but will decline significantly over the next few years

The Bank's balance sheet remains large by historical standards, reflecting the policy measures introduced by the Bank in response to the pandemic (Graph 3.9; Graph 3.10). Since the previous *Statement*, the size of the balance sheet is little changed. The composition of liabilities changed as government deposits declined and ES balances rose, largely owing to payments related to government debt maturities exceeding proceeds from new issuance over the period. The Bank's balance sheet will decline significantly over the coming years as Term Funding Facility (TFF) funding matures over 2023 and 2024 and the Bank's government bond holdings mature over a number of years.

Bank bond issuance declined in recent months

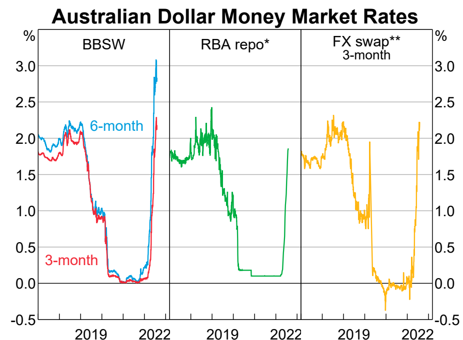
Bank bond issuance declined in recent months, but it remains high over the year to date following strong issuance in the March quarter (Graph 3.11). Banks raised $30 billion in bond markets during the June quarter, with an

Graph 3.7



* Latest market economists' projections as at 3 August 2022.
Sources: Bloomberg; RBA

Graph 3.8



* Weighted average rate for morning open market operation repos.
** Implied AUD cost via US commercial paper issuance and a cross-currency swap.
Sources: ASX; Bloomberg; RBA; Tullet Prebon; US Federal Reserve

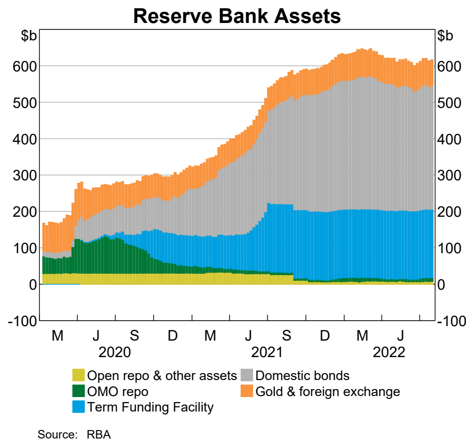
average tenor of around four years, which is a little lower than the average of recent years. Covered bond issuance was relatively high in the quarter at $10 billion. This may reflect increased investor preference for secured products given the increased uncertainty about the economic outlook.

Bank bond yields remain around their levels of three months ago, after increasing sharply in the earlier part of the year. Yields on three-year bonds neared 5 per cent in June for the first time since 2012, before declining back to below 4 per cent more recently (Graph 3.12). These recent movements were broadly in line with those in the swap rate (a reference rate for the pricing of fixed-income securities), with the spread to the swap rate also widening a little further since early May.

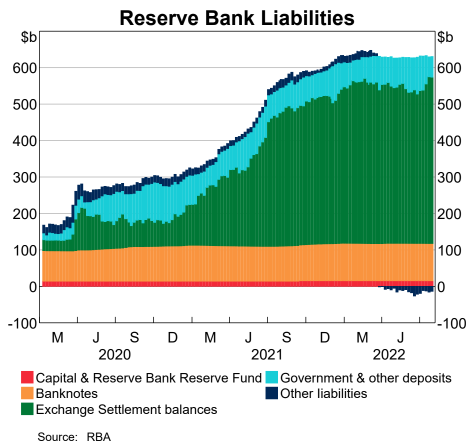
Issuance of RMBS by banks increased, while issuance by non-banks declined and spreads have widened

Issuance of residential mortgage backed securities (RMBS) remained robust in the June quarter and saw the first issuance by a major bank since 2021, although issuance by non-banks declined. Major and non-major banks accounted for almost half of the $9 billion issued, which is their highest share since the TFF was announced in early 2020 (Graph 3.13). The low level of bank issuance prior to this was

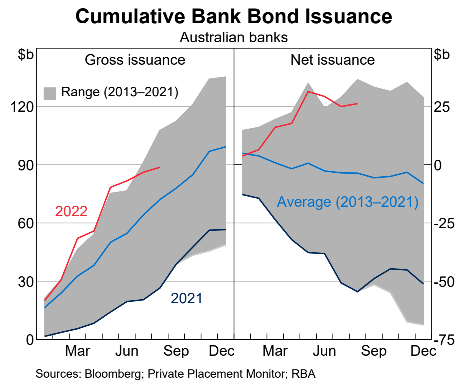
Graph 3.9



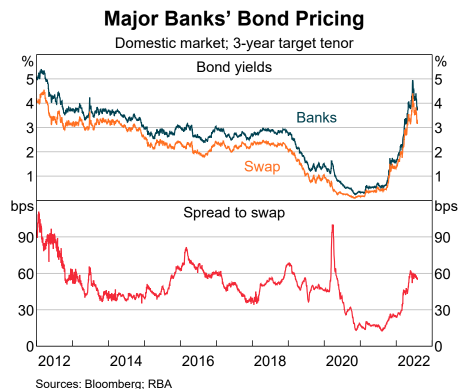
Graph 3.10



Graph 3.11



Graph 3.12



consistent with banks' ready access to alternative funding sources, including the TFF. Spreads on RMBS have widened since early in the year to be slightly above the average seen in the decade preceding the pandemic. Market liaison suggests that conditions since late February have been a little more challenging than over the preceding year or so. For example, some issuers had to increase efforts to contact potential investors to preplace notes.

Banks' funding costs have increased

Banks' overall funding costs have risen with the ongoing increase in market yields and the increases in the cash rate since May, to around the levels seen just before the pandemic. Much of banks' wholesale debt and deposit costs (new and existing) are linked to BBSW rates (either directly or via hedging), which have risen sharply owing to actual and expected increases in the cash rate (Graph 3.14). The increased cost of issuing long-term wholesale debt, such as bonds, is also adding to banks' funding costs. As noted above, bond yields have risen from very low levels in 2021 and remain around their level of three months ago. The spread to the swap rate has widened a little further in recent months. Banks' bond issuance over the year to date has been high by historical standards, as banks respond to the wind-down of the Committed Liquidity Facility over 2022 and TFF maturities from next year. Increases to deposit rates are also putting upward pressure on banks' funding costs.

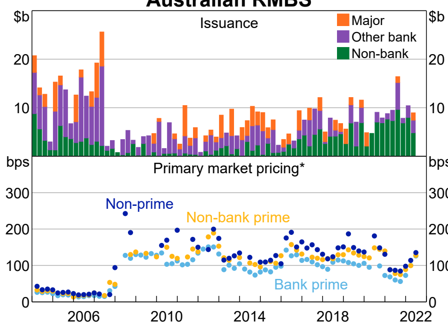
Rates on term and at-call deposits have increased

Banks raise around 60 per cent of their funding in the form of deposits. Since May, banks have increased rates paid on both at-call and term deposits. The average rate paid on at-call deposits – which make up the bulk of banks' deposits – rose by less than the cash rate over the June quarter (Graph 3.15). This is likely to have remained the case over July, based on changes in advertised rates. Increases to at-call deposit rates for households have been larger for savings products that require depositors to adhere to certain conditions to earn interest (e.g. the balance must increase in the month) than for online savings products without conditions. Some of the largest increases in deposit rates have been offered by smaller banks.

Banks have increased rates on new term deposits for both households and wholesale depositors since May. By contrast, earlier increases had largely been to wholesale term deposit rates. These tend to be priced with reference to BBSW rates, which moved higher

Graph 3.13

Australian RMBS



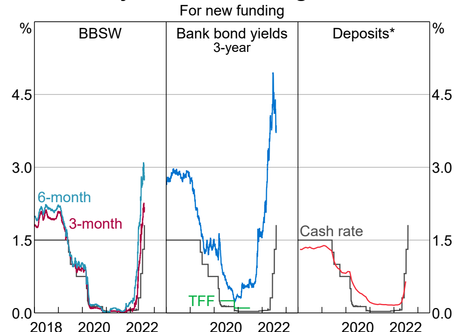
* Face-value weighted quarterly average of the primary market spread to bank bill swap rate for AAA-rated notes. Non-resident RMBS pricing not included.

Sources: Bloomberg; KangaNews; RBA

Graph 3.14

Major Banks' Funding Costs

For new funding



* RBA estimates; excludes deposits in housing loan offset accounts.

Sources: AFMA; APRA; ASX; Bloomberg; major banks' websites; RBA; Refinitiv

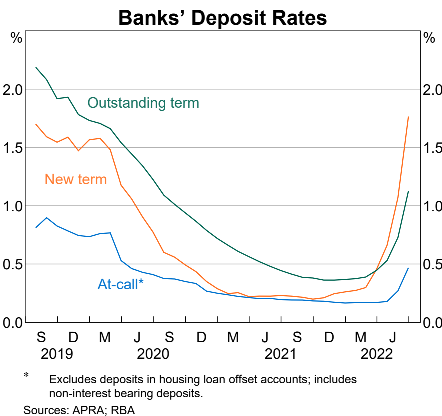
earlier in anticipation of increases in the cash rate. Interest rates paid on outstanding term deposits have also increased, as maturing deposits have been replaced with new, higher-rate term deposits. As the spread between rates on new term and at-call deposits has widened, funding sourced from term deposits has increased, after falling steadily since early 2019 (Graph 3.16).

Interest rates on variable- and fixed-rate housing loans have risen …

Most housing lenders have passed on the cash rate increases up to July in full to their standard variable rates (SVRs), which serve as reference rates for the roughly 65 per cent of outstanding housing credit that is on a variable rate (Graph 3.17). However, average interest rates paid on outstanding variable-rate loans increased by slightly less than the cash rate over May and June (which is the latest available data) (Table 3.1). In part, this reflects lags in reported effects due to timing differences in borrowers' repayments. In addition, variable interest rates on new loans remain lower than those on outstanding loans, and some existing borrowers are likely to have refinanced at these lower rates with a different lender or renegotiated the rate of their existing loan with their current lender.[1] At the time this *Statement* was finalised, some lenders had announced full pass-through of the August increase in the cash rate to their housing reference rates.

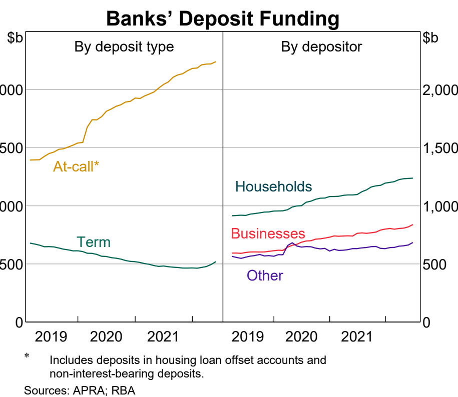
The average rate paid on new fixed-rate housing loans rose further alongside increases in swap rates, which are the pricing benchmark for these loans. As fixed rates on new loans have increased to be noticeably above rates on new variable-rate loans, the share of new lending at fixed rates has declined and is now well below early-2020 levels. The increase in the average rate paid on outstanding fixed-rate loans has been relatively modest, as existing fixed-rate loan terms gradually expire.

Graph 3.15



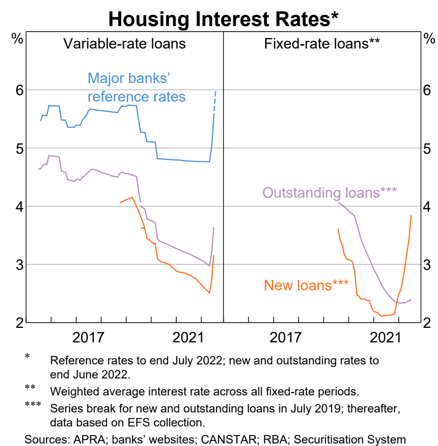
* Excludes deposits in housing loan offset accounts; includes non-interest bearing deposits.
Sources: APRA; RBA

Graph 3.16



* Includes deposits in housing loan offset accounts and non-interest-bearing deposits.
Sources: APRA; RBA

Graph 3.17



* Reference rates to end July 2022; new and outstanding rates to end June 2022.
** Weighted average interest rate across all fixed-rate periods.
*** Series break for new and outstanding loans in July 2019; thereafter, data based on EFS collection.
Sources: APRA; banks' websites; CANSTAR; RBA; Securitisation System

Table 3.1: Average Outstanding Housing Rates
June 2022

	Interest rate (per cent)	Change since Apr 2022 (basis points)	Change since Feb 2020 (basis points)
Cash rate target	0.85	75	10
Variable-rate loans			
– Owner-occupier	3.52	65	–6
– Investor	3.88	67	–9
All variable-rate loans	3.64	66	–7
Fixed-rate loans			
– Owner-occupier	2.28	5	–145
– Investor	2.63	4	–138
All fixed-rate loans	2.40	4	–146
Loans by repayment type[(a)]			
– Principal-and-interest	3.12	44	–50
– Interest-only	3.71	47	–51

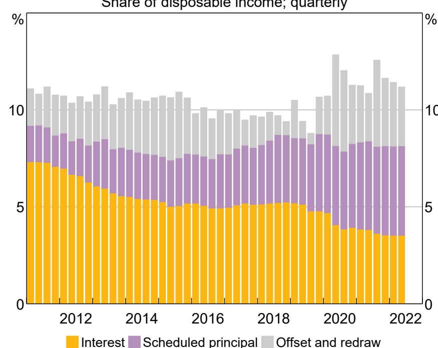
(a) Weighted average across fixed- and variable-rate loans.

Sources: APRA; RBA

… which has started to flow through to a rise in interest payments on housing loans

Interest payments on housing loans increased slightly in the June quarter reflecting the pass-through of the May and June cash rate increases to variable-rate borrowers (Graph 3.18). Pass-through of the increase in the cash rate in July and August will lead to further increases in interest payments over the coming months. Even so, the level of interest payments on housing loans will respond more gradually to changes in interest rates than in the past due to the higher fixed-rate share of credit (currently around 35 per cent of housing credit, compared with 20 per cent prior to the pandemic). The majority of these loans were issued at very low interest rates and will only be subject to a change in mortgage rates upon expiry of their fixed-rate period. Around one-quarter of total housing credit comprises loans with a fixed-rate period due to end in the next two years (Graph 3.19). These loans were taken out at an average fixed rate of around 2.4 per cent.

Net payments into offset and redraw accounts have declined a little since mid-2021, but remain above pre-pandemic levels. Since the onset of the pandemic in early 2020, mortgage borrowers' payments into offset and redraw accounts have been substantial, totalling around $100 billion (which equates to about 6¼ per cent of annual household disposable income). As a result, the median variable-rate



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

owner-occupier borrower had a repayment buffer equivalent to 1½ years' scheduled repayments at interest rates in late June.

Interest rates on business loans have risen from historical lows

Interest rates on variable-rate loans to small and medium-sized enterprises (SMEs) have increased over recent months (Graph 3.20). The major banks and a number of smaller banks have passed on the cash rate increases up to July in full to their published small business indicator rates (the pricing benchmark for many small business variable-rate products). As at June (the latest data available), the average variable rate paid on outstanding SME loans had increased by less than that on new loans, reflecting the usual lag in the adjustment of interest rates on existing variable-rate loans. Average outstanding variable rates on large business loans have also increased in recent months, rising by around 100 basis points between March and June. These rates are typically linked to the three-month BBSW rate, which has risen sharply since the start of the year.

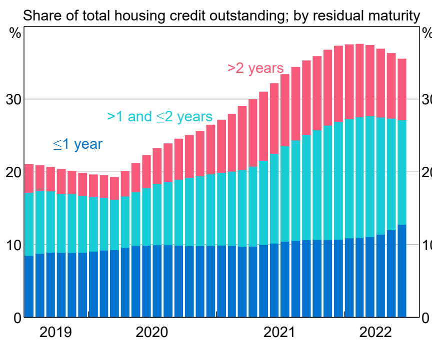
Interest rates on fixed-rate loans to businesses have also picked up. In particular, average interest rates on new fixed-rate loans for SMEs – which account for just under 12 per cent of business loans by value – have increased sharply since the start of the year, following the rise in longer-term swap rates (a key pricing benchmark for fixed-rate loans).

Growth in credit remains high

Growth in total credit has remained high in recent months, at around its fastest pace in more than a decade (Graph 3.21; Table 4.2). Total housing credit growth was little changed over the June quarter, while business credit growth picked up further, supported by robust business conditions, increased business investment and high levels of merger and acquisition (M&A) activity over the past year. Personal credit continued to decline over the first half of 2022, but at a slower pace than in late 2021. This is consistent with a recovery in consumer spending following the easing of lockdowns at the start of the year.

Demand for housing loans has eased but remains high

Housing credit growth remains around 7¾ per cent on a six-month-ended annualised basis. Owner-occupier credit growth has moderated over recent months, while investor credit growth has remained steady after picking up over 2021 (Graph 3.22).



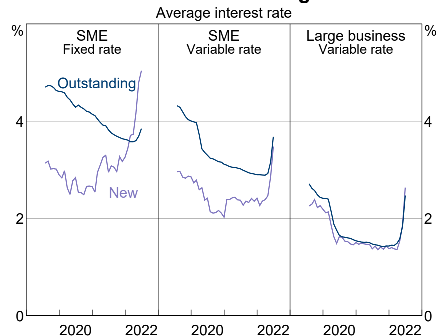


Table 3.2: Growth in Financial Aggregates

Percentage change[(a)]

	Three-month annualised		Six-month annualised	
	Mar 22	Jun 22	Dec 21	Jun 22
Total credit	7.9	11.1	8.7	9.5
– Household	7.1	7.1	7.2	7.1
– Housing	7.8	7.6	8.0	7.7
– Owner-occupier	8.3	7.6	9.2	8.0
– Investor	6.9	7.6	5.6	7.2
– Personal	–2.2	–0.1	–4.2	–1.2
– Business	9.3	19.6	12.1	14.3
Broad money	5.3	10.0	12.4	7.6

(a) Figures are break-adjusted and seasonally adjusted.

Sources: ABS; APRA; RBA

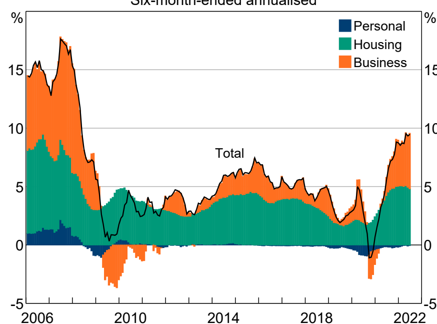
Commitments for housing loans have declined across most states in the June quarter, consistent with slowing activity in the housing market, decreases in housing prices in a number of markets and rising interest rates (and the prospect of further rate rises). Commitments to owner-occupiers and investors have eased but remain close to their highest levels on record (Graph 3.23). Commitments to first home buyers have steadily declined since their peak in 2021, but remain above pre-pandemic levels.

Growth in lending to businesses has picked up further in recent months

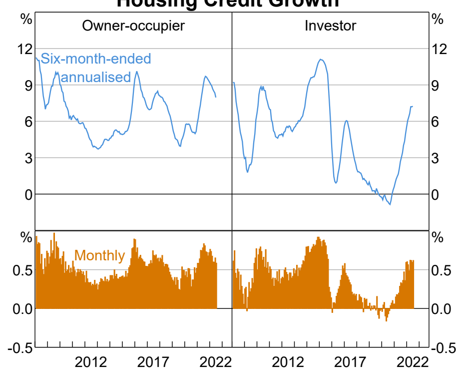
Growth of business lending has increased to the fastest pace in more than a decade. Growth has been driven by lending to medium-sized and large businesses, while lending to small businesses has been little changed for some time (Graph 3.24).

Businesses' demand for debt finance has been strong, and liaison suggests banks are meeting this demand, especially for larger businesses. Commitments for new business loans remain well above their average of the past decade.

Graph 3.21

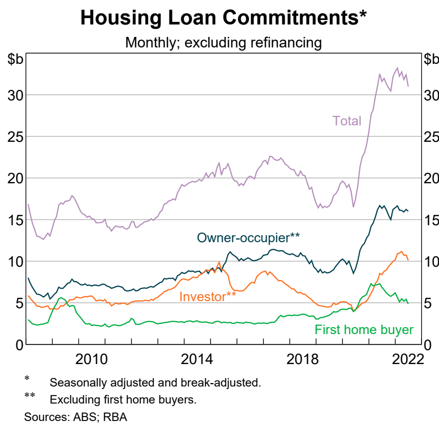


Graph 3.22



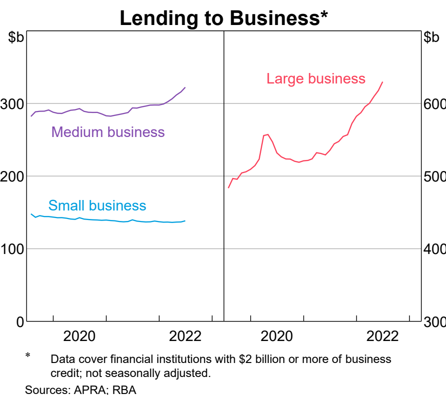
Views on the outlook for business lending are mixed. Some banks expect lending growth to remain strong over the year, particularly for medium-sized and large firms, supported by strong economic conditions, the lagged effect on debt of high levels of M&A activity over the past 12 months and growth in business investment. However, other banks expect economic uncertainty, rising input costs and rising interest rates to contribute to some slowing in demand for additional debt. The mixed outlook for business lending was reinforced in July by participants at the Reserve Bank's annual Small Business Finance Advisory Panel – drawn from small businesses across Australia – which provided valuable perspectives on the financial conditions facing small businesses.[2]

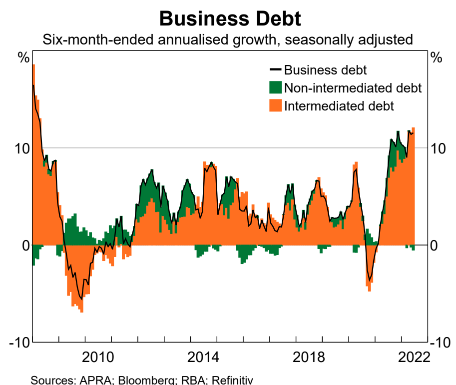
Up until the end of June, government loan guarantee schemes supported some lending to SMEs. These schemes have now closed to new applications. As at May 2022, around $15 billion in total loan commitments had been made since April 2020 under the SME Guarantee Scheme and SME Recovery Loan Scheme (compared with around $220 billion in total SME loan commitments).



Growth of broader business debt remains strong

Growth in a broader measure of business debt remains well above the average of recent years, supported by continued strong growth in business credit (Graph 3.25). Notwithstanding this, weaker growth in non-intermediated debt has contributed to a slight easing in overall growth of business debt in recent months. Bond issuance in the year to date is well below average (Graph 3.26). Most issuance in the June quarter was in offshore markets; over half was issuance from resource-related corporations in their first issuance in bond markets this year.



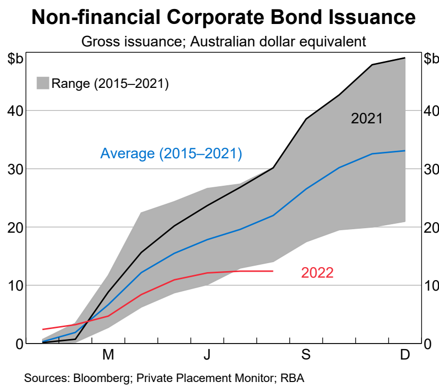


Australian equity prices declined alongside falls in global markets

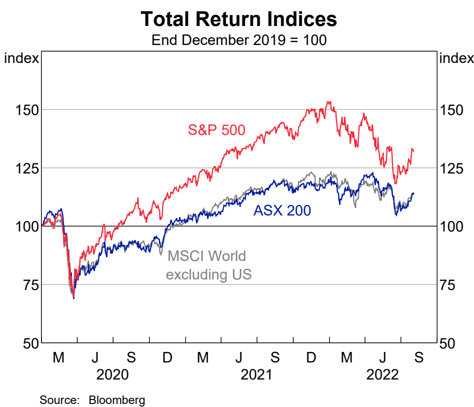
The ASX 200 index has fallen by 8 per cent, on a total return basis, since its peak in April (Graph 3.27). The decline broadly mirrored that in overseas markets, reflecting the rise in interest rates and the prospect of further increases, as well as concerns around global growth. Equity market volatility has risen to be above the medium-term average in Australia and abroad, given some rise in uncertainty about the economic outlook.

Falls in the ASX over recent months have been led by the resources sector. Materials stock prices are down by 16 per cent since mid-April, due to falls in the price of iron ore owing to concerns about growth in China (Graph 3.28). Energy stocks are down by 2 per cent, as global energy prices have partly retraced the significant increase that followed Russia's invasion of Ukraine. Falls were also seen across most other sectors, although defensive sectors – such as health care, consumer staples and industrials, which tend to have more consistent earnings across the economic cycle – outperformed the index.

Graph 3.26



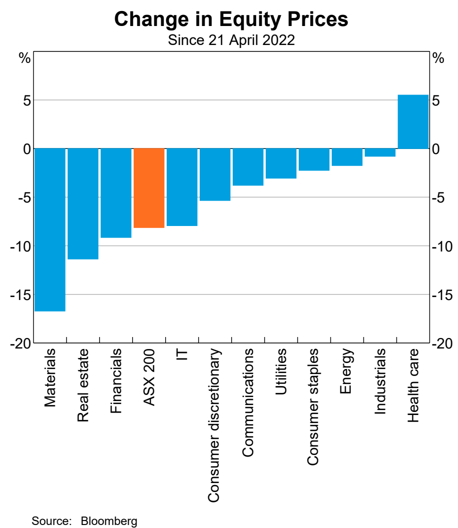
Graph 3.27



Equity raisings have remained subdued

Equity raisings have declined in 2022, after a high level of activity in 2021. Liaison indicates that a number of initial public offerings have been deferred recently, but are expected to proceed when market conditions become more favourable. Overall, close to $600 million was raised by companies listing on the ASX in the June quarter, largely in the resources sector (Graph 3.29).

Graph 3.28



The Australian dollar has appreciated of late after depreciating over the preceding months

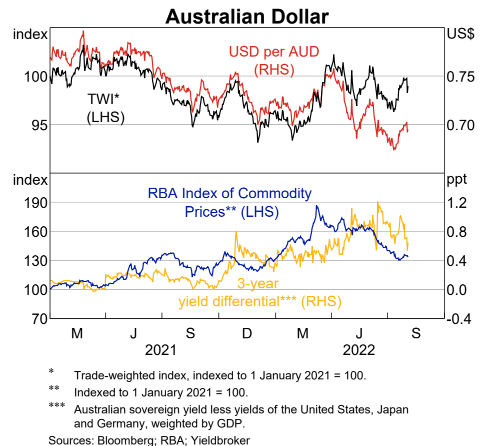
The Australian dollar has appreciated over recent weeks, partly reflecting a recovery in the prices of riskier assets alongside some paring back of US policy rate tightening expectations. It has now largely retraced the depreciation over the past few months that occurred amid concerns about global growth, uncertainty about the outlook for the Chinese economy and broad US dollar strength (see chapter on 'The International Environment'). Over recent months, the RBA index of commodity prices has fallen by around 15 per cent, to be around its levels at the beginning of the year (Graph 3.30). Short-term yields on Australian Government bonds have declined relative to those on government bonds in the major advanced economies compared with a few months ago.

The Australian dollar is 4 per cent lower against the US dollar over the year to date, while on a trade-weighted (TWI) basis it is 3 per cent above its levels at the beginning of the year (Graph 3.31). The difference largely reflects the appreciation of the Australian dollar against the Japanese yen and the euro. The Australian dollar is also slightly higher against the Chinese renminbi – which accounts for the largest weight in the TWI basket. The current level of the Australian dollar is consistent with estimates of its fundamental levels, based on historical relationships with the forecast terms of trade and yield curve differentials.

Australia's financial account deficit narrowed in the March quarter

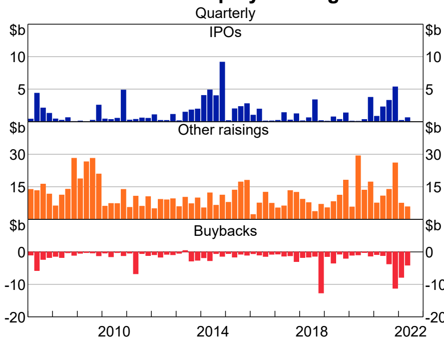
The narrowing of Australia's financial account deficit in the March quarter was associated with a smaller net outflow of capital over the same period. Net capital outflows were driven by debt-related investment abroad from Australia's financial sector; this was partly offset by inflows,

Graph 3.30



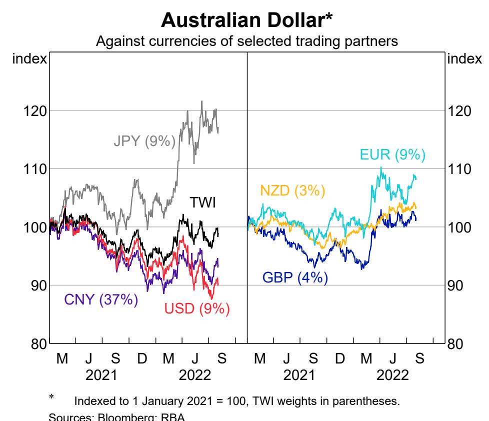
* Trade-weighted index, indexed to 1 January 2021 = 100.
** Indexed to 1 January 2021 = 100.
*** Australian sovereign yield less yields of the United States, Japan and Germany, weighted by GDP.
Sources: Bloomberg; RBA; Yieldbroker

Graph 3.29



* All listed companies.
Sources: ASX; RBA

Graph 3.31



* Indexed to 1 January 2021 = 100, TWI weights in parentheses.
Sources: Bloomberg; RBA

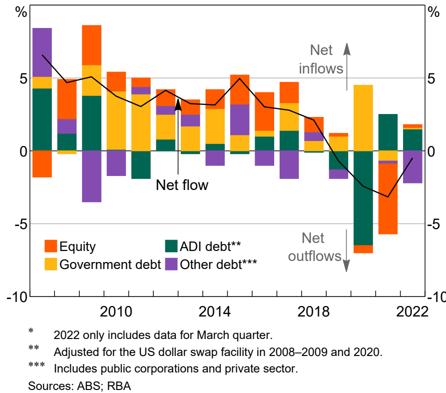
as Australian banks increased the amount of debt issued in offshore markets (Graph 3.32).

Australia's net foreign liability position as a share of GDP is at its lowest level since the 1980s, having decreased further over the quarter (Graph 3.33). The recent decline reflected a decrease in the long-term foreign debt liability position. By contrast, Australia's foreign equity asset position decreased for the first time since 2020, reflecting valuation effects associated with the exchange rate and declining international equity prices.

Graph 3.32

Net Capital Flows*

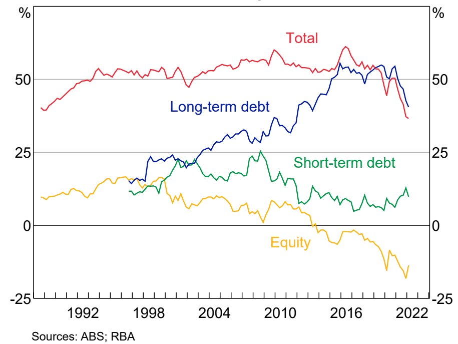
Per cent of GDP



Graph 3.33

Net Foreign Liability Position

Per cent of GDP



Endnotes

[1] While SVRs serve as reference rates for variable-rate loans, most borrowers receive a discount to the reference rate. See RBA (2019), 'Box D: The Distribution of Variable Housing Interest Rates', *Statement on Monetary Policy*, November. Available at <https://www.rba.gov.au/publications/smp/2019/nov/box-d-the-distribution-of-variable-housing-interest-rates.html>

[2] Further detail will be available in the forthcoming article: McCowage M and L Nunn, 'The Current Climate for Small Business Finance', RBA *Bulletin*, September.