Speech

Restrictive Financial Conditions in Australia

RESERVE BANK OF AUSTRALIA

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I thank the Australian Banking Association (ABA) for inviting me to this conference.

On the occasion of the ABA's 70th anniversary, it would be tempting to look back over the history of banking in Australia. Instead, I will focus on current financial conditions, which is of interest to those in the banking industry and indeed to Australians more generally.

The tightening in monetary policy over the past two years is underpinning restrictive financial conditions in Australia. This is contributing to slower growth of aggregate demand, thereby helping to bring the level of demand into better balance with supply and lower inflation. While recent economic data have been mixed, they have reinforced the need to remain vigilant to upside risks to inflation. Hence, with regards to the path of interest rates, the Reserve Bank Board is not ruling anything in or out.

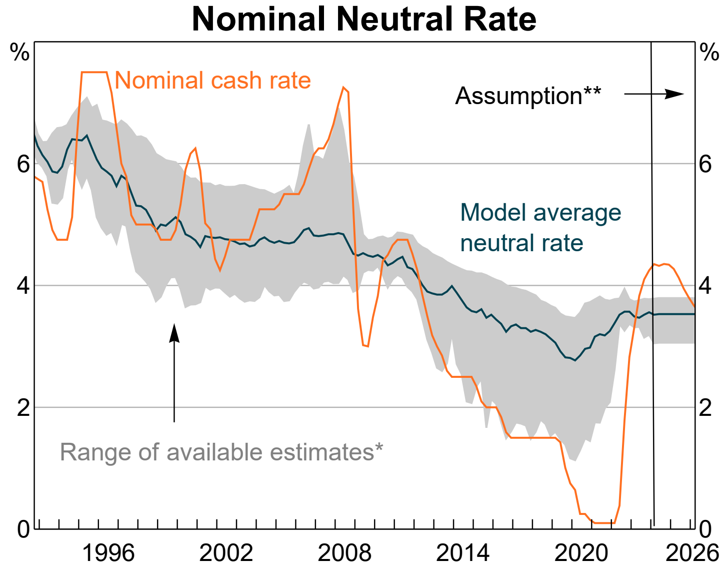
Financial conditions are particularly restrictive for households, but less so for larger businesses. Higher interest rates work through several channels and their effects will vary across different households and businesses according to their circumstances, including their indebtedness and the shape of their balance sheets more broadly.

Monetary policy is restrictive

Monetary policy is the key determinant of financial conditions for households and businesses. Since May 2022, the RBA has raised the cash rate target by 425 basis points. We know that many are feeling a painful squeeze on their finances because of higher interest rates. High inflation, though, has also reduced people's purchasing power. It has adversely affected all households, but especially those on lower incomes.

One way to gauge the stance of monetary policy is to compare the cash rate with estimates of the nominal neutral interest rate (Graph 1).[1] Definitions of the neutral rate vary, but in essence it is the level of the cash rate that would neither stimulate nor restrain demand; in other words, it would underpin a balance between demand and supply of goods and services and in the labour market, with inflation consistent with the inflation target.

Graph 1



* Range of central estimates corresponding to available models. Nominal neutral rates are defined using trend inflation expectation.

** The nominal cash rate assumption is based on market pricing for overnight indexed swaps (OIS) on June 24, 2024.

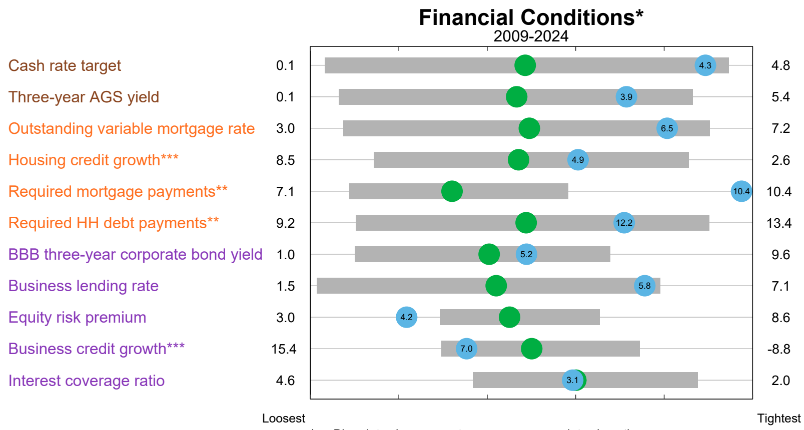
Sources: LSEG; RBA.

Currently, the cash rate is above our range of estimates of the nominal neutral rate.[2] This follows a period before and during the pandemic when it was below neutral. The cash rate is also above most estimates of the nominal neutral rate provided by market economists surveyed by the RBA. In May, the median estimate among market economists implied that the cash rate was around 1 percentage point above the nominal neutral rate.[3] In short, these estimates imply that monetary policy is restrictive and so it is continuing to bring aggregate demand into better balance with aggregate supply, as intended.

That said, estimates of the neutral rate are subject to considerable uncertainty, so the extent to which monetary policy is restrictive is unclear. Also, the neutral rate can change over time. Indeed, our (model-average) estimates for Australia have increased since the pandemic, as have some estimates for other economies.[4] Factors cited as drivers for the recent increase include: increases in public debt globally; downward pressure on savings due to demographic changes, such as the baby boomer generation moving into retirement; and increases in investment, from both the public and private sectors, including to support the green energy transition.[5] Moreover, there are many methodological and conceptual choices involved in estimating the neutral rate. As my former colleague Luci Ellis put it, estimates of the neutral rate only cast a faint light to guide monetary policy-makers.[6]

We can also assess financial conditions by examining a broad set of indicators that complement the signals we take from the real economy. The dashboard of indicators presented in the following graph point to financial conditions being restrictive (Graph 2). This is most obvious for the benchmark measures of interest rates and for financial conditions faced by households. Conditions appear to be less tight for larger businesses.

Graph 2



* Blue dots show current measures, green dots show the average over the sample and the grey bars show the middle 80 per cent of observations.
** Calculated as a share of household disposable income.
*** Six-month annualised.
Sources: ABS; APRA; ASX; Bloomberg; CoreLogic; major banks' websites; RBA.

There is a lot in this dashboard, so I will step through it carefully. The scale of each row corresponds to the range of these measures since the global financial crisis (GFC).[7] The grey shaded area shows the typical range of outcomes (as indicated by the central 80 per cent of the distribution). The blue dots are the most recent value for each measure. The further a dot is to the right, the tighter are financial conditions along that dimension (relative to the period norms), and the further left, the looser are conditions.

The green dots are the average since the GFC. We need to be careful, though, because the neutral level of an indicator can rise or decline over time for various reasons. So, a deviation from the average of the sample may not give a true measure of the degree of tightness right now. For example, the measure of required mortgage payments as a share of household disposable income is at its highest since the GFC, but total household debt payments are not. This difference reflects the downward trend in personal credit over that period.

The two measures shown at the top of the dashboard are key benchmark interest rates and are currently higher than their historical averages. As mentioned earlier, the cash rate target has been raised by 425 basis points since May 2022. The three-year government bond (AGS) yield is below the level of the cash rate, but still quite a bit higher than its post-GFC average.

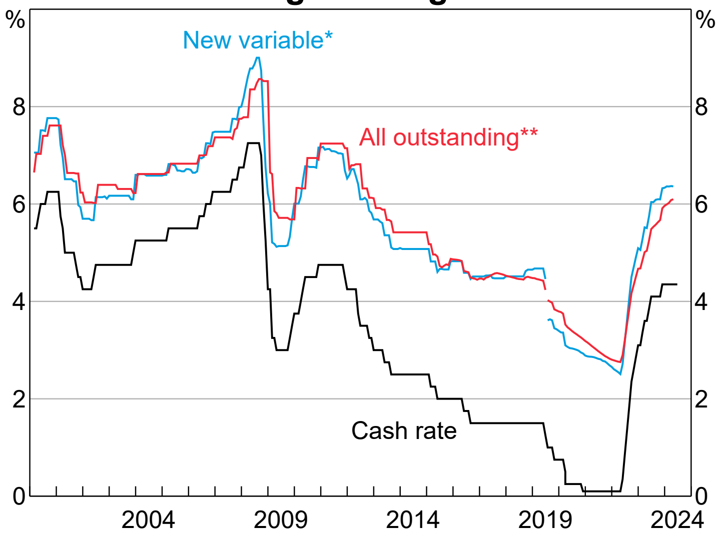
The middle four measures relate to financial conditions faced by households. They are quite tight. Finally, the bottom five measures show financial conditions faced by businesses. These are less tight than for households.[8]

Overall financial conditions are restrictive for households

While higher interest rates affect the decisions of all households, the effects of tighter monetary policy are felt most directly by the roughly 40 per cent of Australian households with a mortgage.[9] The average rate on outstanding mortgages has risen by 335 basis points over the tightening phase to date, to a little over 6 per cent. Pass-through has been a bit less than in the past because of the high share of mortgages fixed at low rates during the pandemic.[10] Increased discounting on mortgages by lenders competing for borrowers has also played a role. Nevertheless, the increase in mortgage rates has been large and rapid (Graph 3). Also, most of the remaining low fixed-rate loans from the pandemic era will expire this year, which will add around 20 basis points to the average outstanding mortgage rate.

Graph 3

Housing Lending Rates



* Perpetual data used to 2013; advertised package rates to July 2019; thereafter, data from the EFS collection.

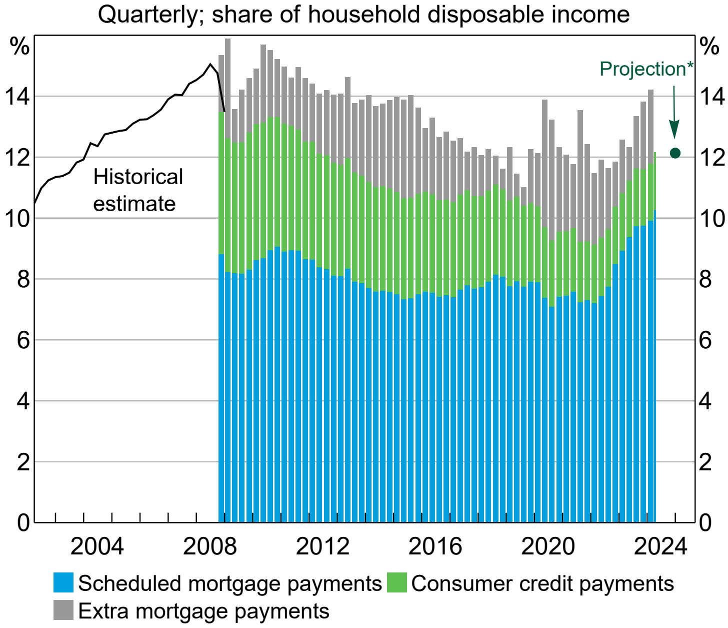
** Perpetual data used to 2015; data from the Securitisation System to July 2019; thereafter, data from the EFS collection.

Sources: APRA; Perpetual; RBA; Securitisation System.

While mortgage rates are below the peak in 2007, households hold a bit more mortgage debt (as a share of household disposable income) than in previous tightening phases. As a result, scheduled mortgage payments – which include mortgage principal and interest – have increased to a record 10 per cent of household disposable income (shown by the blue bars in Graph 4). Our estimates suggest that total scheduled debt payments (which include payments on consumer credit) have also increased sharply (these are shown by the top of the green bars). However, total scheduled debt payments by households remain below earlier peaks because the stock of consumer credit has declined significantly since 2008. Meanwhile, extra payments into mortgage offset and redraw accounts (shown in grey) have held up despite the increase in scheduled debt payments – I will come back to this point soon.

Graph 4

Selected Claims on Household Income



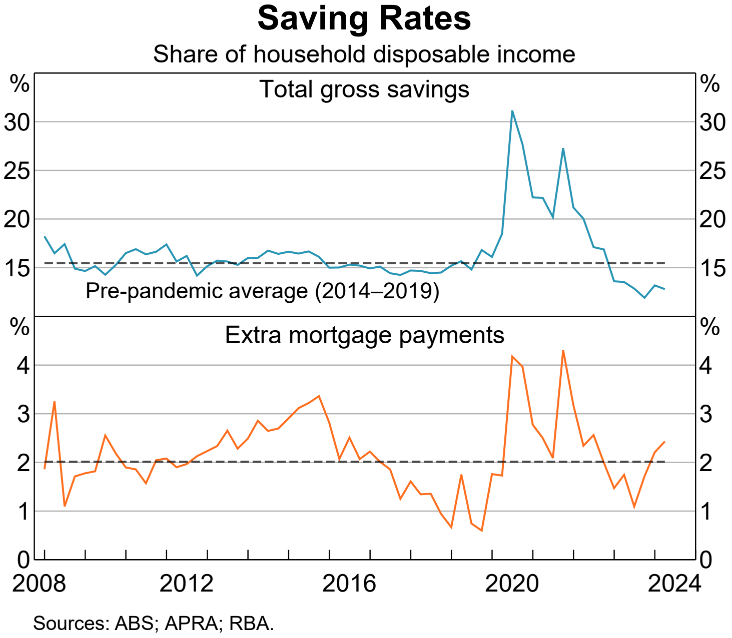
* Projection for total scheduled payments on household debt at end-2024, based on the current level of the cash rate.

Sources: ABS; APRA; RBA.

The rise in scheduled debt payments has put additional pressure on the budgets of many households and contributed to weakness in consumption growth. While many indebted households – and particularly those on lower incomes – have felt these budget pressures acutely, nearly all borrowers are servicing their debts on schedule. Much of this reflects the resilience of the labour market; even though conditions there are gradually easing, they remain tight. The share of credit card balances accruing interest remains low, suggesting that most households are responding to cost-of-living pressures via some combination of consuming less or saving less than in the past. Growth in employment has supported some households' ability to service their debts.

Higher interest rates are providing an incentive for all households to save more and borrow less. For households with a mortgage, despite higher debt-servicing costs and other pressures on disposable incomes, payments into offset and redraw accounts have increased as a share of income over recent quarters (Graph 5). Flows of these extra payments are now a bit above their pre-pandemic average. By contrast, the gross savings rate across all households has declined and is now below pre-pandemic levels.

Graph 5

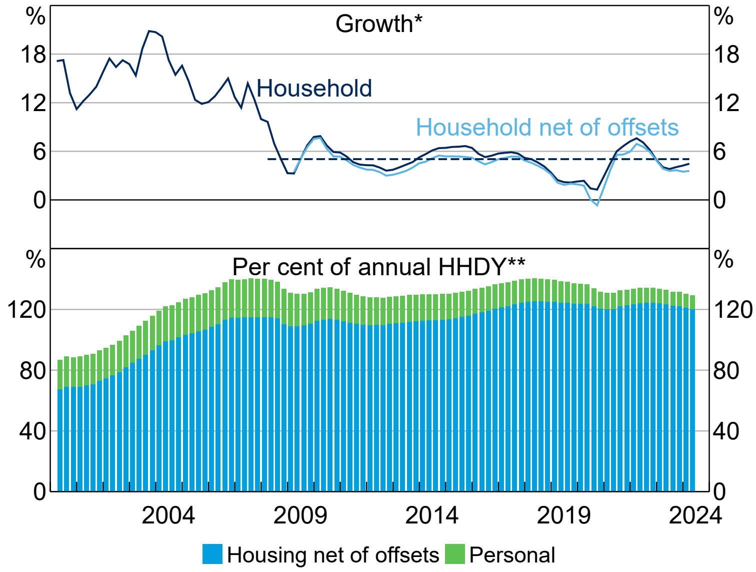


The different behaviour of these two series reflects a combination of things, including differences in measurement approaches and economic factors. One such factor is that households with a mortgage face a strong incentive to keep their savings in offset and redraw accounts because these accounts earn a high tax-adjusted rate of return when interest rates are high. High interest rates also provide an incentive for households without debt to save more than they would otherwise. And while the savings rate of the household sector has declined, higher interest rates are still likely to be influencing savings decisions. Indeed, households facing a range of pressures on their disposable incomes are responding by restraining their consumption of discretionary items and saving less. However, households overall are still saving. Moreover, both households with a mortgage overall, and the broader household sector still have substantial stocks of additional savings that were built up during the pandemic. That's not true, though, for all households, with many having run down any savings to support consumption in the face of significant budgetary pressures.

As expected, higher interest rates have weighed on household credit growth (Graph 6). While household credit growth has picked up a little since early 2023 – alongside rising housing prices – it remains a bit below average. And after deducting offset balances, household credit growth has been flat for the past year or so. Moreover, the level of household credit (net of offset accounts) has declined as a share of household disposable income. The decline in this measure of household indebtedness is apparent in several other indicators. For example, average loan-to-value ratios for new loans have declined over this phase of monetary policy tightening. Also, loan discharges from property sales have increased, and by more than the rise in new lending (which is shown as commitments in Graph 7). These trends are likely to reflect incentives to reduce or limit indebtedness in response to higher interest rates.

Graph 6

Household Credit



* Six-month-ended annualised; dashed average post-2008 calculated gross of offsets.

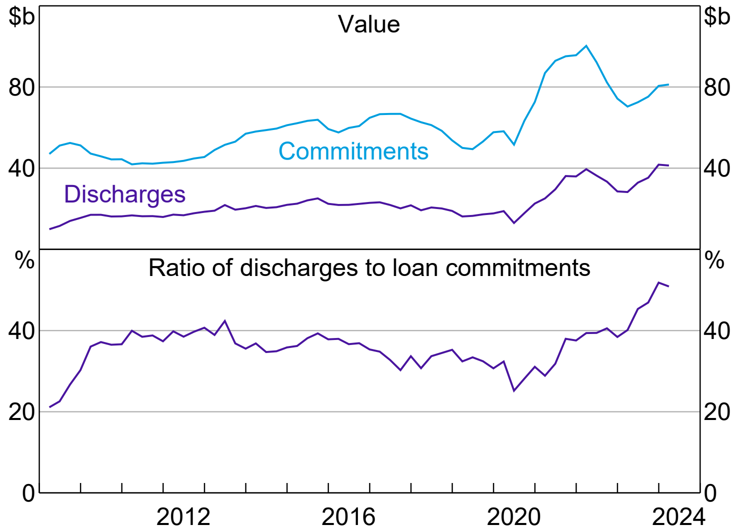
** Household disposable income.

Sources: ABS; APRA; RBA.

Graph 7

Housing Loan Discharges*

Quarterly; seasonally adjusted



* Discharges and commitments are net of external refinancing.

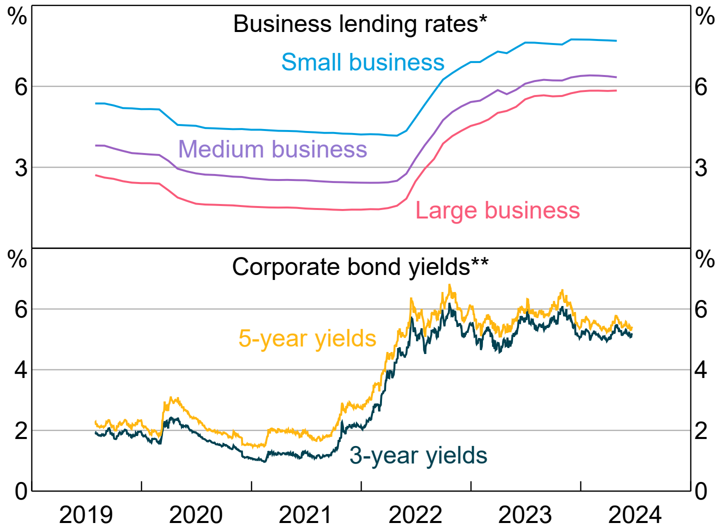
Sources: ABS; APRA; RBA.

Increases in the cash rate have led to tighter financial conditions for businesses

Increases in the cash rate have also flowed through to higher business lending rates and higher corporate bond yields, although pass-through has varied across different markets (Graph 8). Average rates on large business loans have increased by more than 425 basis points over the tightening phase, compared with around 310 basis points for small businesses. However, small businesses continue to face substantially higher interest rates than their medium and large counterparts. Large businesses with access to wholesale funding markets have benefited from favourable conditions in those markets. In particular, corporate bond yields have risen by less than the rise in risk-free yields over the tightening phase because credit spreads have narrowed noticeably.

Graph 8

Cost of Business Debt



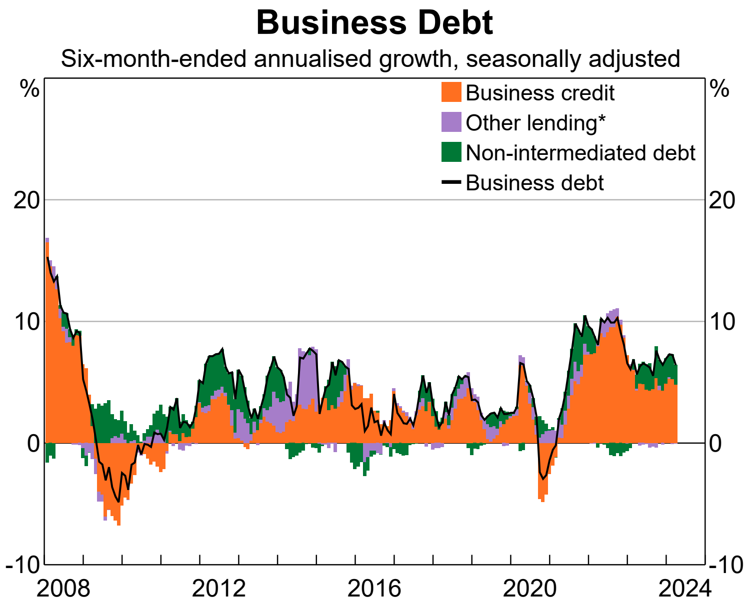
* Average variable interest rate on credit outstanding.

** For BBB-rated non-financial corporations.

Sources: APRA; Bloomberg; RBA.

Despite the rise in the cost of new business debt, the growth of business debt remains above its post-GFC average (Graph 9). This reflects business credit growth remaining above average as well as strong issuance of corporate bonds over the past year or so. Above-average growth of business debt has been supported by relatively strong growth in business investment, although business investment growth has slowed recently. Some businesses have curtailed their investment plans a little in response to cost pressures and the weakness in aggregate demand, and businesses expect the pace of investment growth to slow further in the year ahead. As has been the case for many years, small business lending has not grown over the past year and small businesses report that accessing funding through banks with terms that suit their needs remains a significant challenge.[11]

Graph 9



* Lending to large businesses by institutions that do not report to APRA.

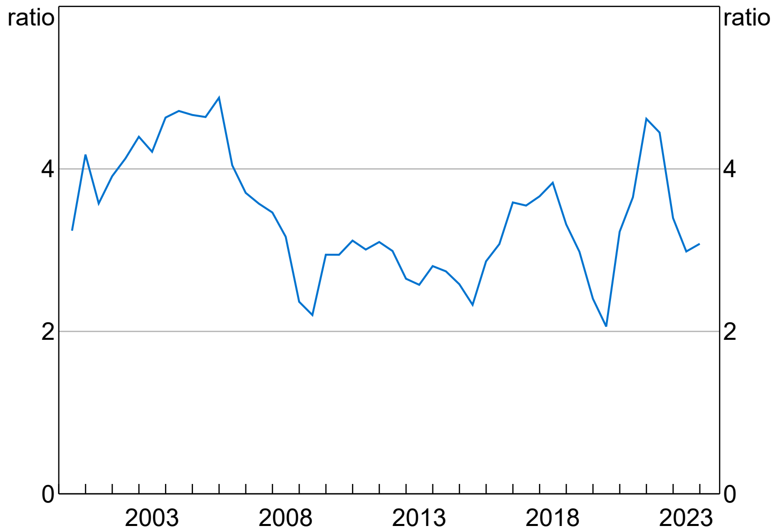
Sources: APRA; Bloomberg; LSEG; RBA.

For many medium and large businesses, the effect of higher interest rates has been partly offset by strong nominal earnings, relatively low leverage and, in some cases, debt that was issued at earlier low fixed rates. Indeed, the median interest coverage ratio of listed companies has declined over the tightening phase but is around its post-GFC average – partly reflecting a long-term decline in gearing (Graph 10). Aggregate leverage of non-financial businesses remains relatively low, at a little over 20 per cent, which is below the pre-pandemic average of nearly 30 per cent. All else equal, this decline in leverage would suggest that monetary policy is having less effect on the average business (than if they were more highly leveraged). Most listed companies also hold cash buffers that are slightly higher than pre-pandemic levels, and many businesses have been in a strong financial position throughout the tightening phase. These trends are likely to have contributed to businesses continuing to borrow at an above-average pace despite higher interest rates. Among smaller businesses, aggregate cash buffers remain above historical average levels. But they have declined over the past year, and information from the RBA's liaison program suggests liquidity buffers are unevenly distributed.

Graph 10

Interest Coverage of Listed Companies*

Median interest coverage ratio



* Leveraged ASX-listed non-financial corporates. Interest coverage ratio calculated as EBITDA/interest expenses.

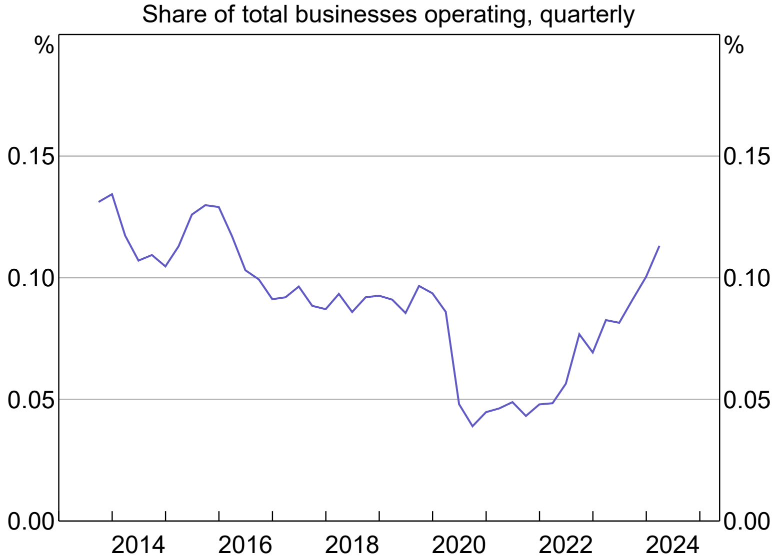
Sources: Morningstar; RBA.

Tighter financial conditions are likely to have had a stronger effect on businesses with higher pre-existing leverage and generally weaker balance sheets, as well as smaller businesses which do not have access to wholesale funding markets. Indicators of business financial stress generally remain low, although many businesses are experiencing challenging conditions and the share of businesses entering insolvency has increased since early 2022 (Graph 11). This is particularly so for businesses in the construction and hospitality sectors, although this follows a period of very low insolvencies owing to pandemic-related support measures. Most of these firms entering insolvency are small businesses with little debt.[12] Rates of non-performing loans have also increased slightly but remain low by historical standards.

Graph 11

Company Insolvencies

Share of total businesses operating, quarterly



Sources: ABS; ASIC; RBA.

Conclusion

Looking across a range of measures shows that monetary policy tightening has led to restrictive financial conditions. However, the extent of this varies across different sectors and also within sectors. Households have been responding to higher interest rates. While households with mortgages are significantly affected, and quite directly, consumption growth is weak for most people. Smaller businesses, and businesses with higher leverage, are also facing financial pressures, much more so than many larger businesses. Notwithstanding these differences, restrictive financial conditions are helping to slow the growth of demand, thereby bringing the level of demand into better balance with supply. This is contributing to the decline in inflation, which is to the benefit of all Australian households and businesses.

Endnotes

[*] I thank Sue Black, Shan Jayawardhana, Dmitry Titkov, Peter Wallis, Charlie Wenk and Ada Zhou for their great assistance in helping to prepare this speech.

[1] I say 'one way to gauge' because the stance of monetary policy is somewhat broader than the current level of the cash rate and incorporates expectations for future cash rates as well as the size and composition of the RBA's balance sheet. However, in normal times, the level of the cash rate relative to the neutral rate is a reasonable summary statistic for the stance of monetary policy.

[2] We use three main types of models for estimating the neutral rate. The first type is a semi-structural model that infers the neutral rate as the cash rate that would prevail in the economy if output was at potential, inflation was at target and employment was full. The second type infers the neutral rate from financial market pricing for government bonds. The third type infers it from a statistical model that attempts to forecast the future level of the cash rate once all cyclical influences have dissipated. See Ellis L (2022), 'The Neutral Rate: The Pole-star Casts Faint Light', Keynote Address to Citi Australia & New Zealand Investment Conference, Sydney, 12 October.

[3] See the J1 statistical table for summary statistics from the RBA's survey of market economists: RBA, 'Statistical Tables'.

[4] Benigno G, B Hofmann, G Nuño Barrau and D Sandri (2024), 'Quo Vadis, r*? The Natural Rate of Interest after the Pandemic', *BIS Quarterly Review*, March.

[5] Benigno *et al*, n 4. Possible causes for the earlier multi-decade decline in the neutral rate include a decline in productivity growth and an increase in risk aversion: see Ellis, n 2.

[6] Ellis, n 2.

[7] We also look at other measures in addition those on the dashboard, including measures adjusted for inflation.

[8] Note that I have not included the exchange rate on the dashboard. It is an important channel of monetary policy transmission, but not the focus of my speech today. The level of the Australian dollar (in real trade-weighted terms) is broadly consistent with the range of model estimates implied by historical relationships with the forecast terms of trade and real yield differentials versus major economies. For details, see Hambur J, L Cockerell, C Potter, P Smith and M Wright (2015), 'Modelling the Australian Dollar', RBA Research Discussion Paper No 2015-12; Chapman B, J Jääskelä and E Smith (2018), 'A Forward-looking Model of the Australian Dollar', RBA *Bulletin*, December.

[9] While net-saver households benefit from higher interest rates, the overall effect on households' net interest income is negative because aggregate household debt is larger than aggregate household holdings of interest-earning assets: see Beckers B, A Clarke, A Gao, M James and R Morgan (2024), 'Developments in Income and Consumption Across Household Groups', RBA *Bulletin*, January.

[10] See Ung, B (2024), 'Cash Rate Pass-through to Outstanding Mortgage Rates', RBA Bulletin, April.

[11] See Chan P, A Chinnery and P Wallis (2023), 'Recent Developments in Small Business Finance and Economic Conditions', RBA *Bulletin*, September.

[12] See RBA (2024), 'Chapter 2: Resilience of Australian Households and Businesses', *Financial Stability Review*, March.