

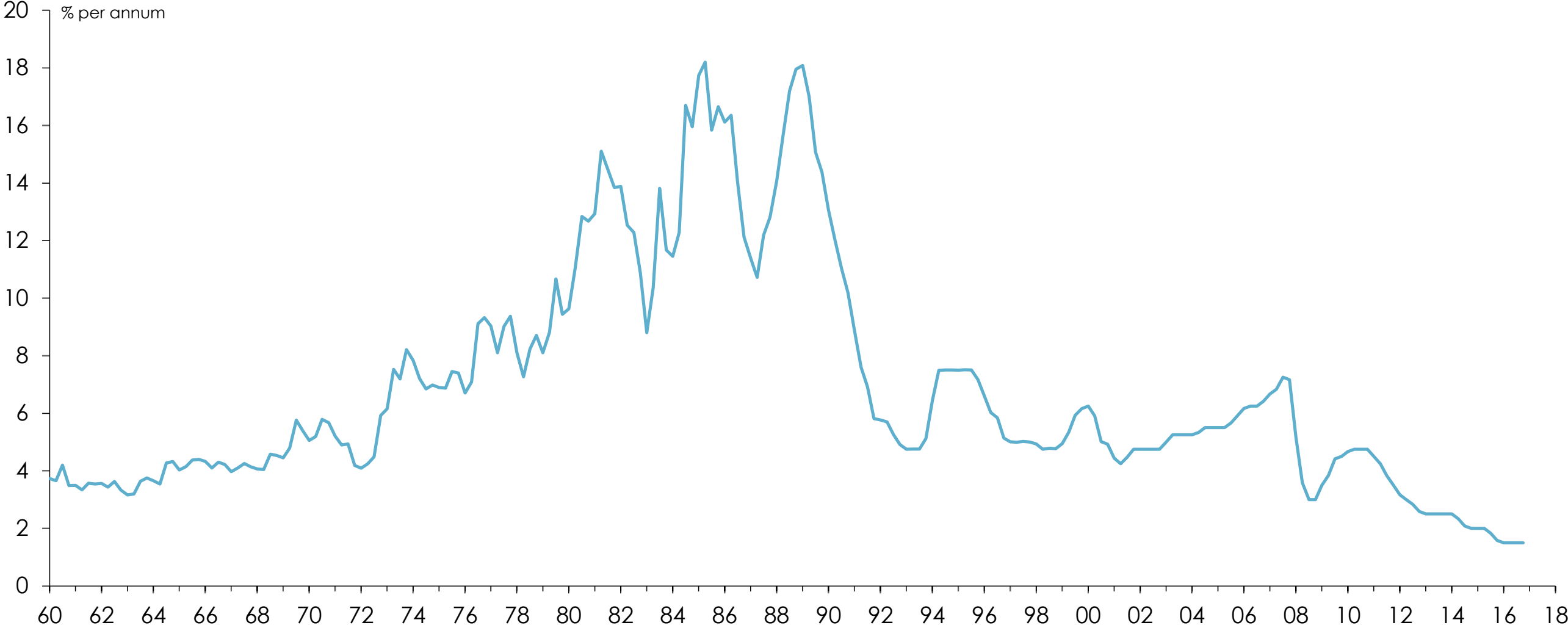
THE AUSTRALIAN ECONOMY, INTEREST RATES AND DEBT

PRESENTATION TO THE KESSLER FORUM 2017

CROWN MELBOURNE – 20TH SEPTEMBER 2017

The Reserve Bank's official cash rate is the lowest it's ever been

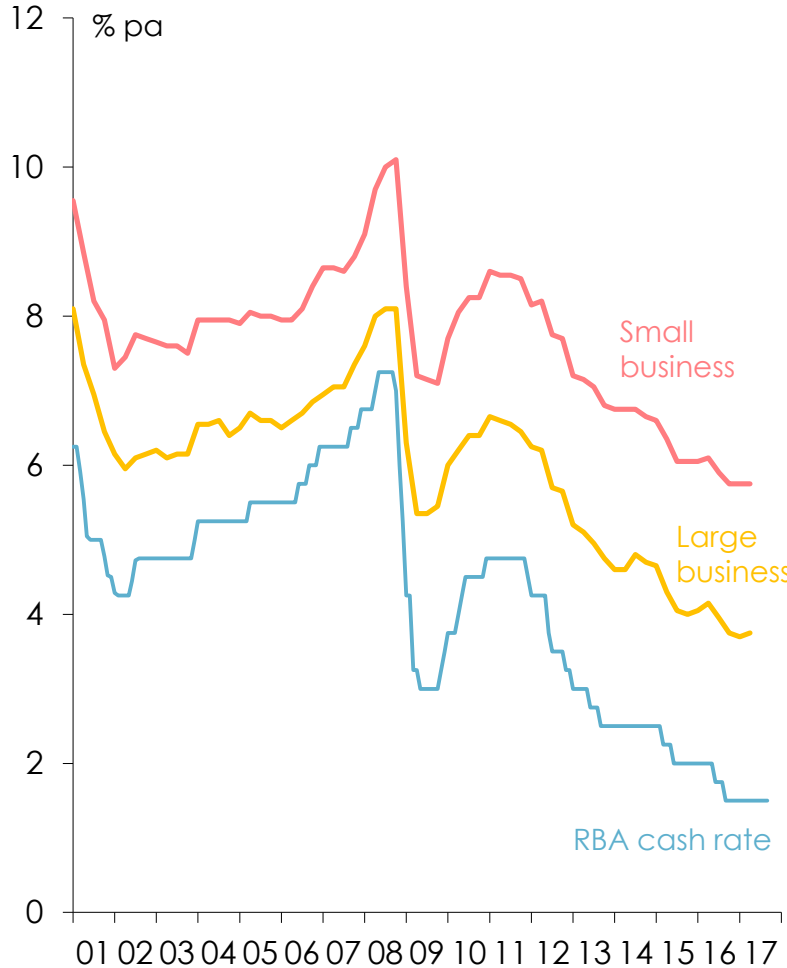
The Reserve Bank's official cash rate



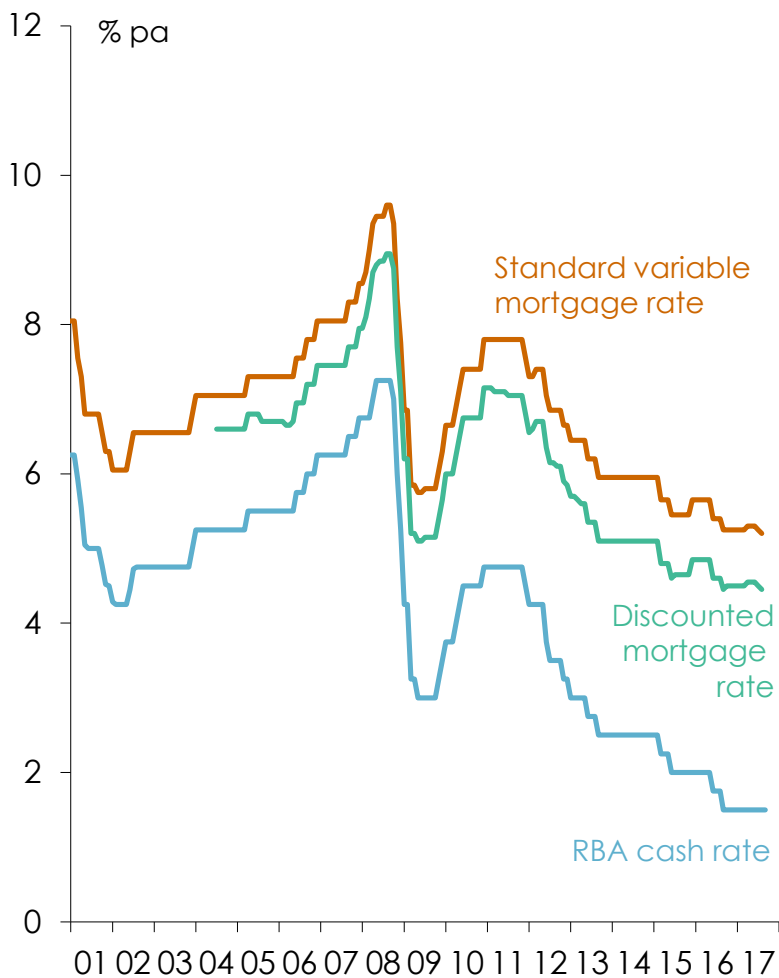
Source: Reserve Bank of Australia.

Interest rates actually paid on business and housing loans are also at record lows - though rates have been rising on some housing loans

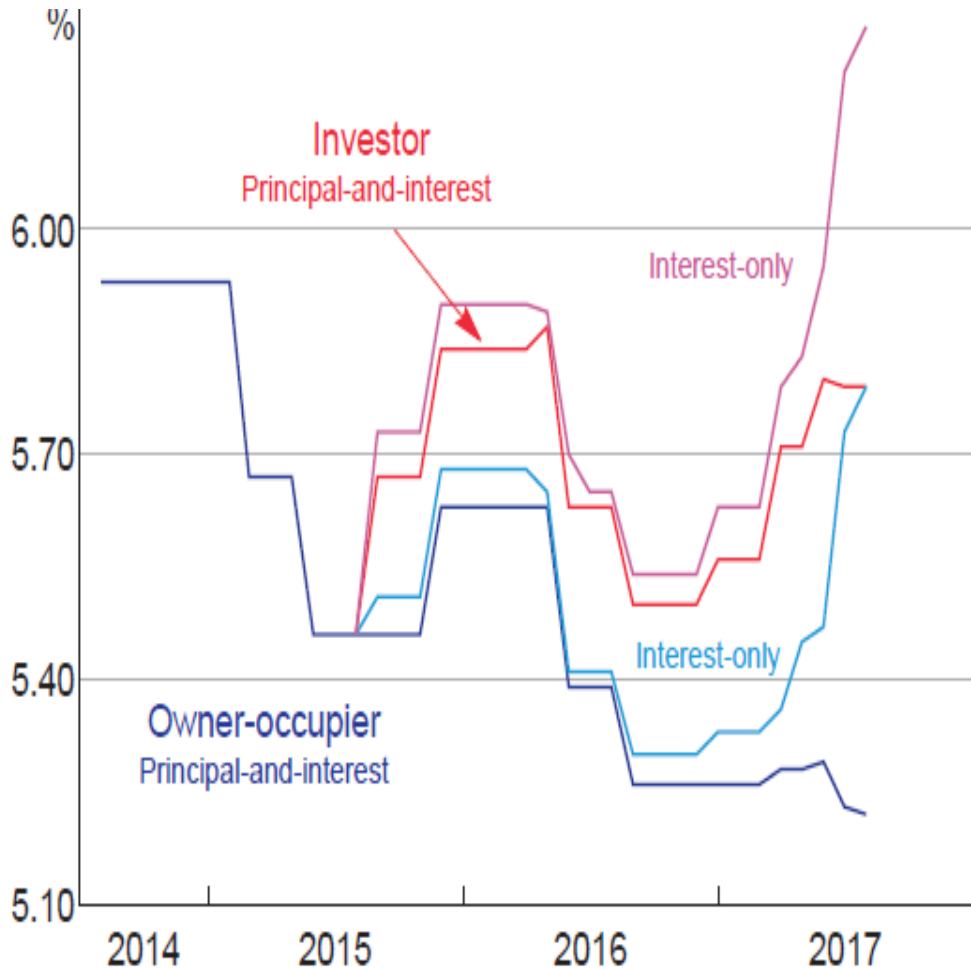
Business loan interest rates



Housing loan interest rates



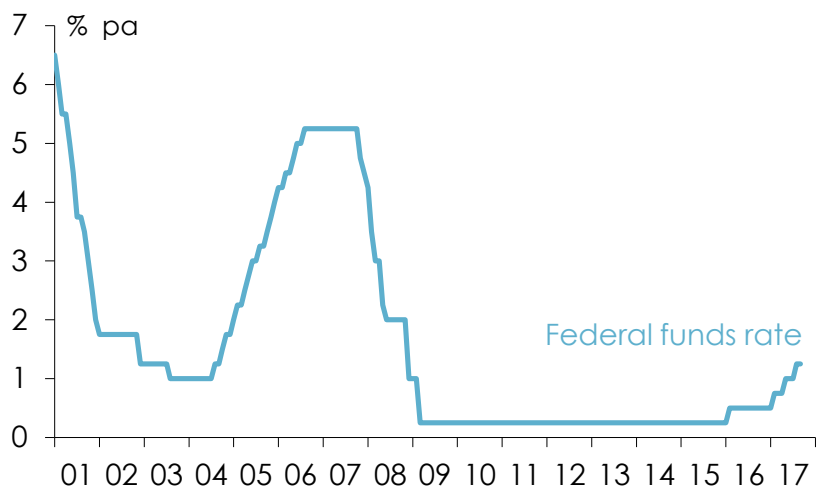
Recent developments in housing loan interest rates



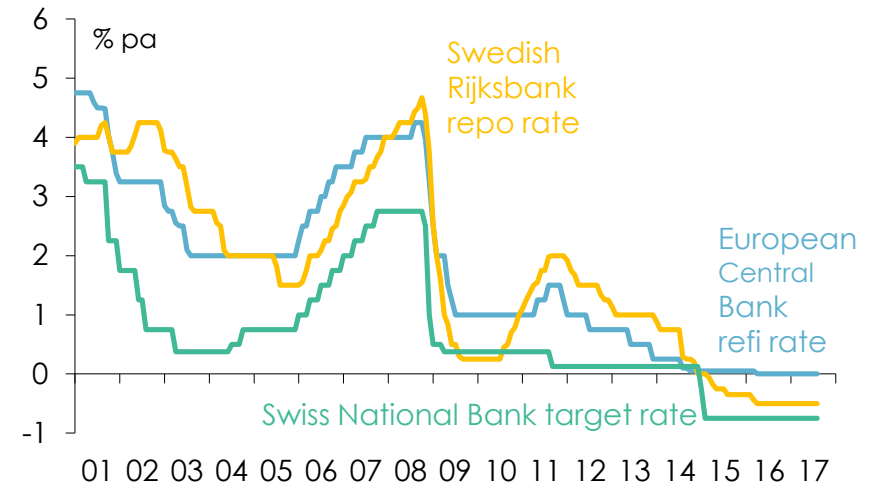
Source: Reserve Bank of Australia.

Interest rates in most major overseas countries fell to even lower levels than Australia after the financial crisis, but some are now starting to rise

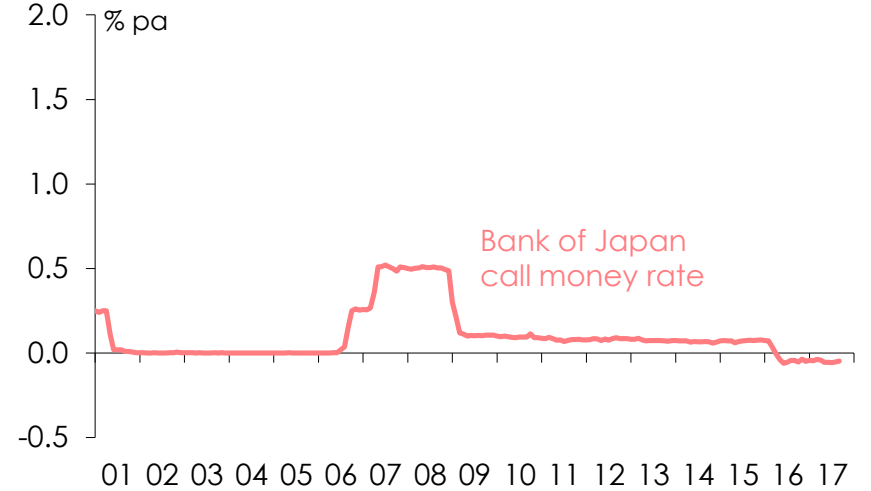
United States



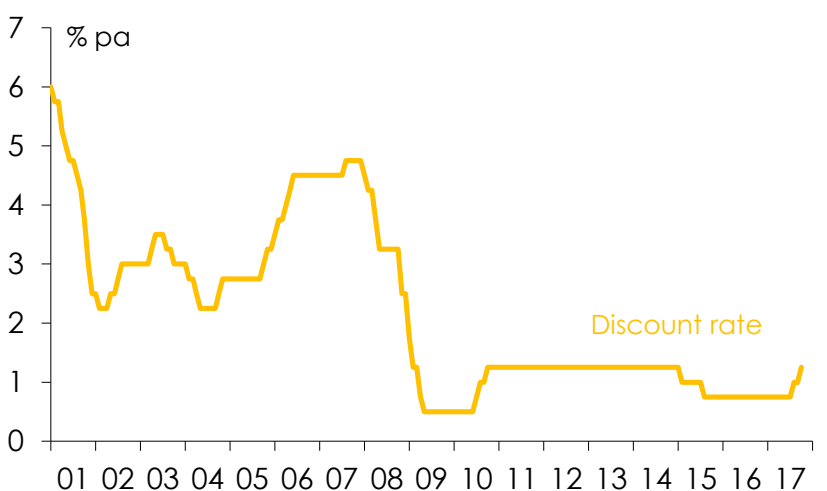
Europe



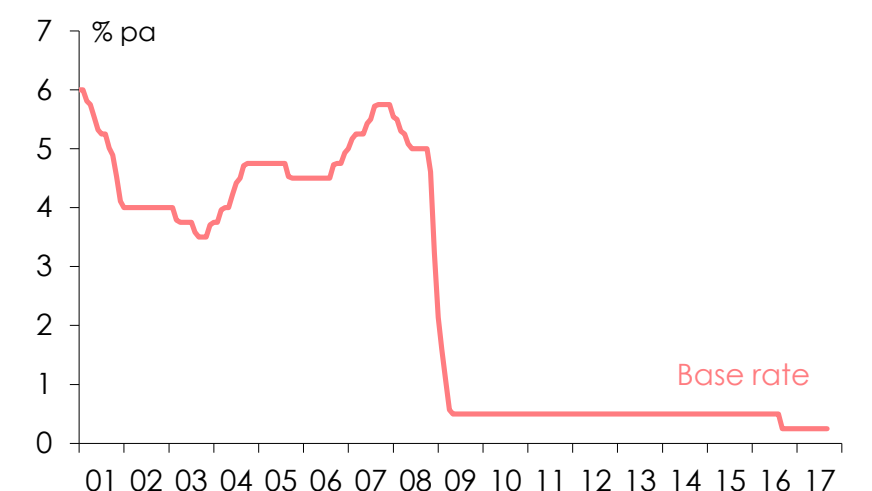
Japan



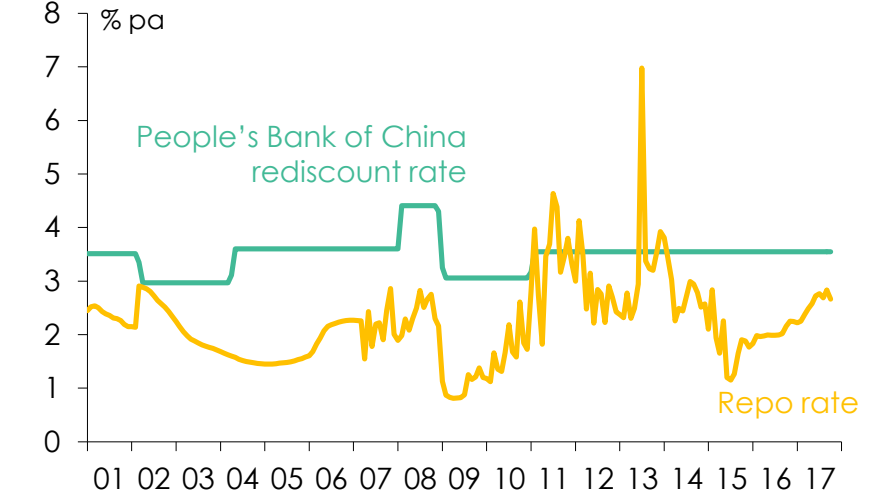
Canada



United Kingdom



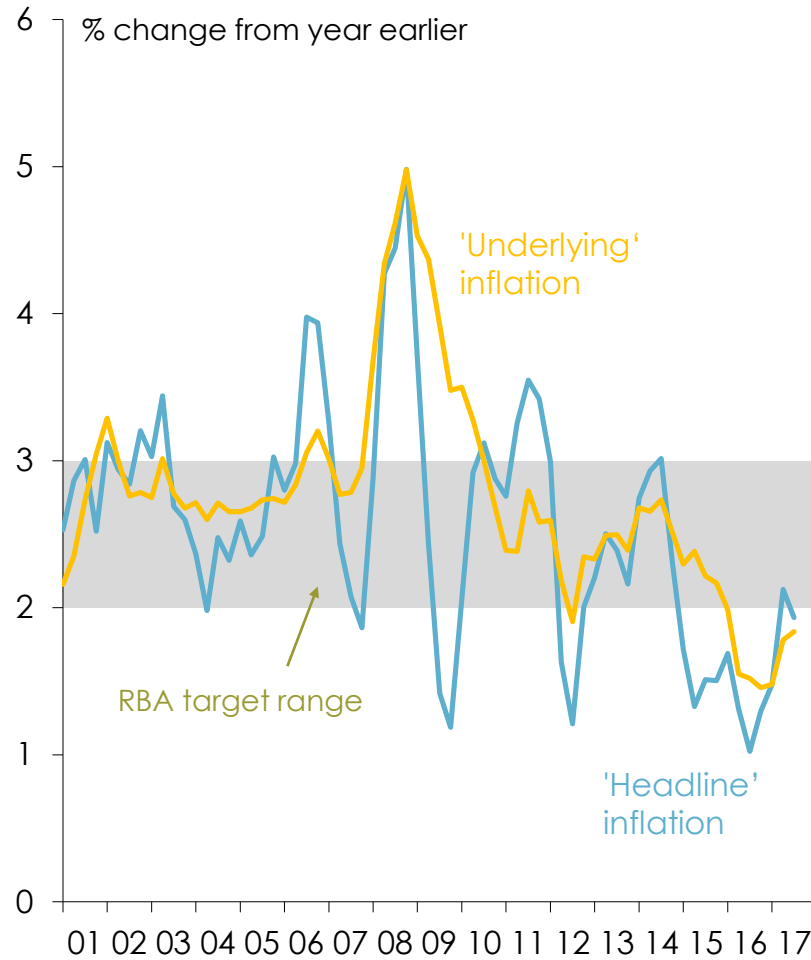
China



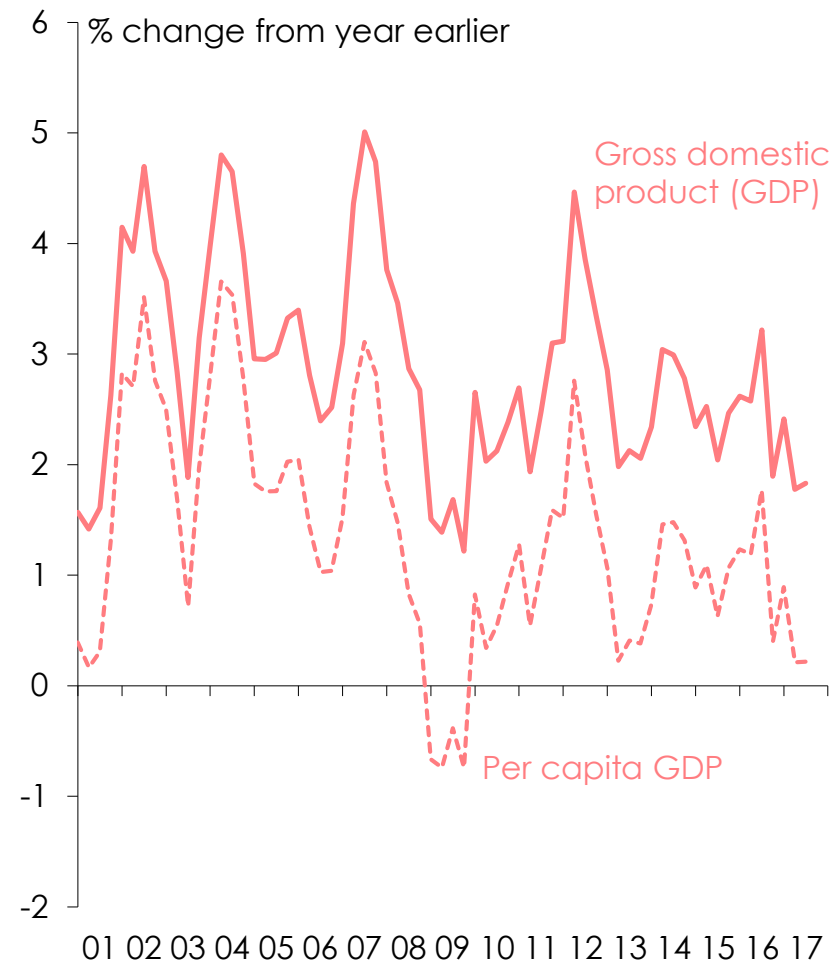
Sources: US Federal Reserve Board; Bank of Canada; European Central Bank; Swedish Riksbank; Swiss National Bank; Bank of England; Bank of Japan; People's Bank of China; Thomson Reuters Datastream.

The RBA wants to see inflation at between 2 and 3%, economic growth at around 3%, unemployment at around 5% and less 'under-employment'

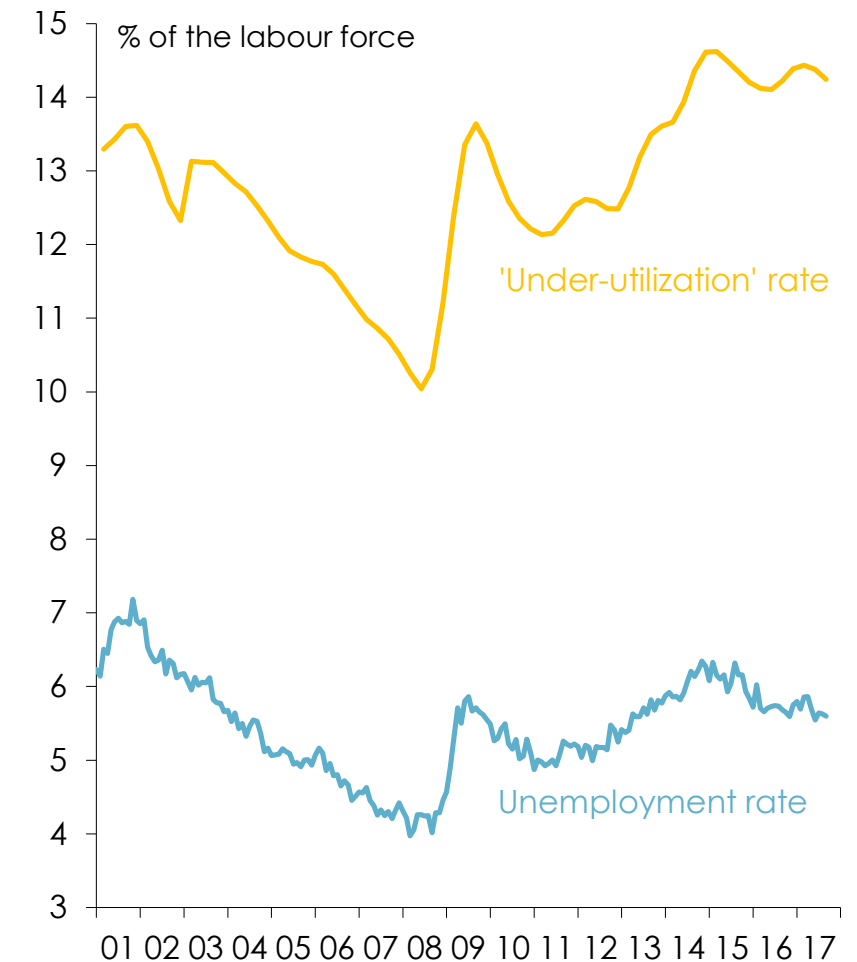
Consumer prices



Economic growth



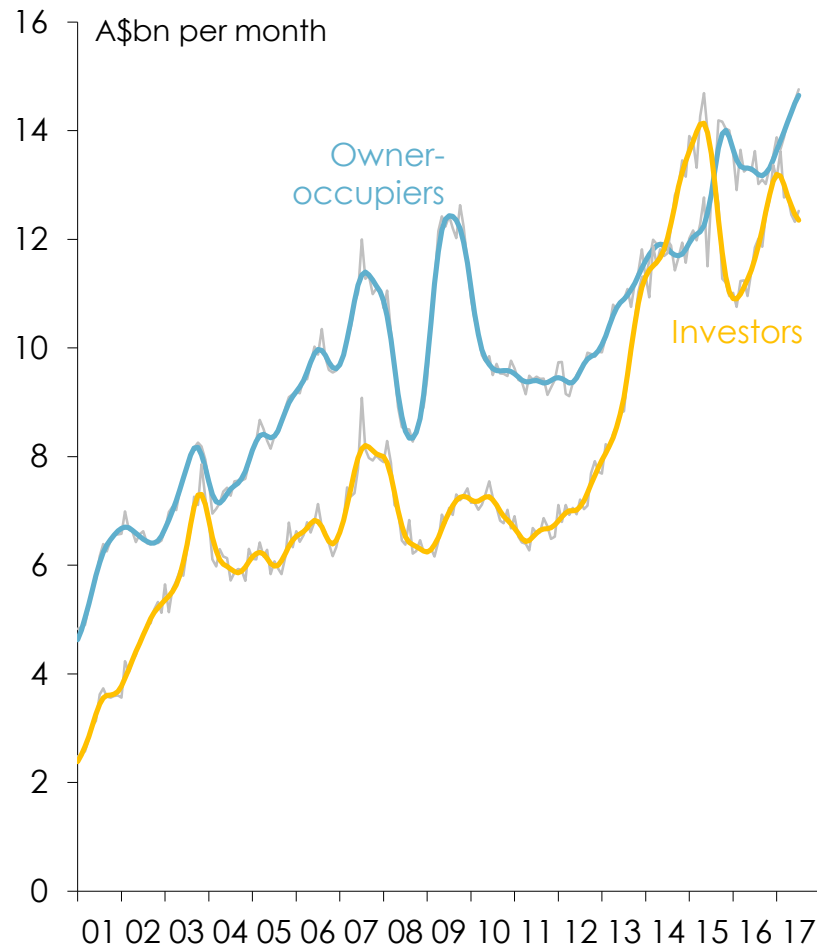
Unemployment and under-employment



Note: 'underlying' inflation abstracts from the impact of volatile items (typically items such as petrol, or fruit and vegetables) on the CPI. The labour force 'under-utilization' rate includes people employed part-time who are willing and able to work longer hours (and weights them equally with people who are 'unemployed' in the conventional sense). Source: Australian Bureau of Statistics.

Record low interest rates promoted a surge in property investment, riskier lending practices, and a further spike in property prices

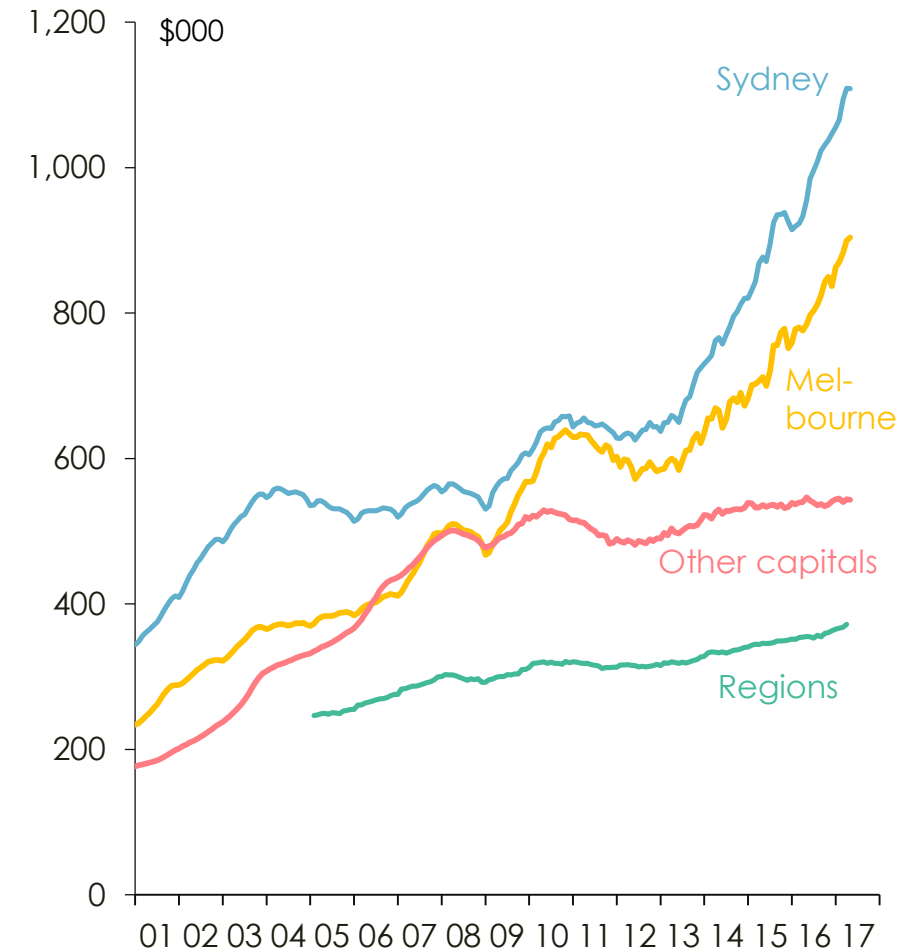
Housing finance commitments



Interest-only loans



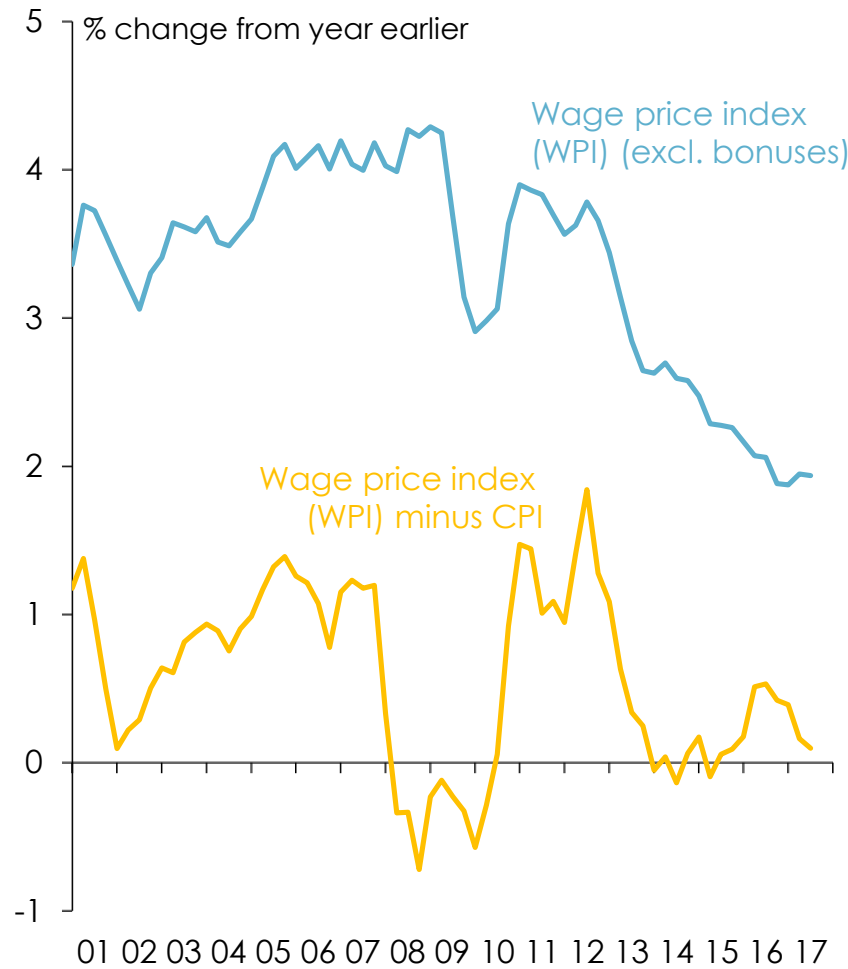
Residential property prices



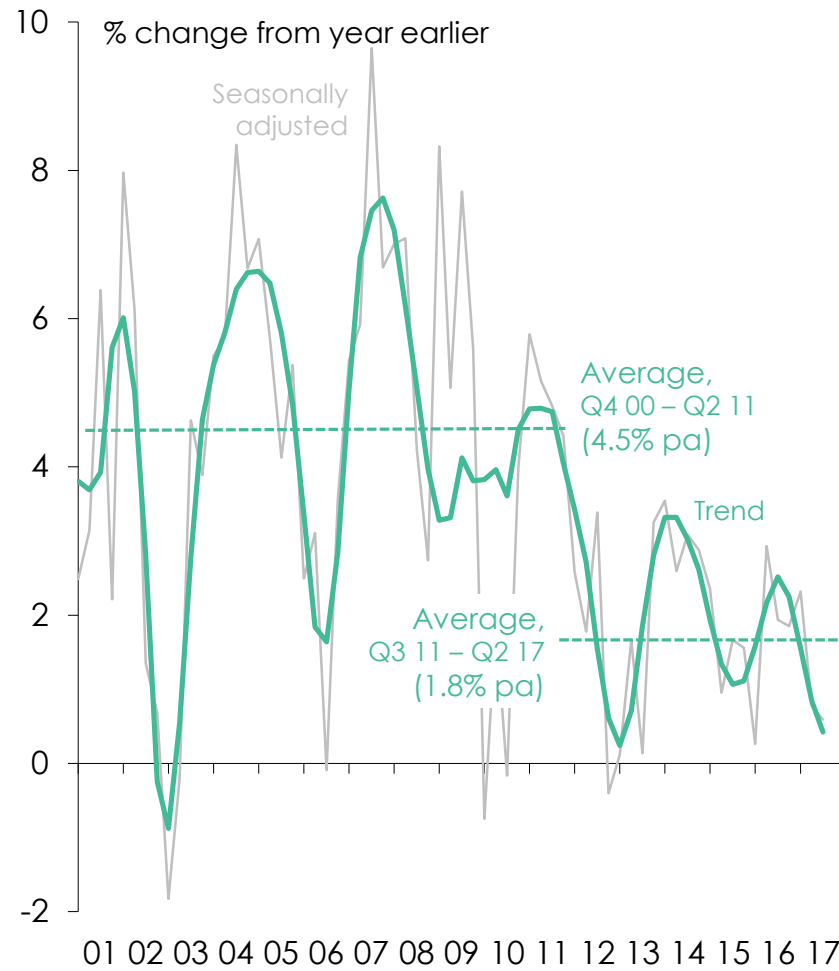
Sources: ABS, Housing Finance (5609.0); Australian Prudential Regulatory Authority, Quarterly Authorized Deposit-Taking Institution Property Exposures; CoreLogic.

Sluggish wages growth has meant weak growth in household incomes and depressed levels of consumer confidence

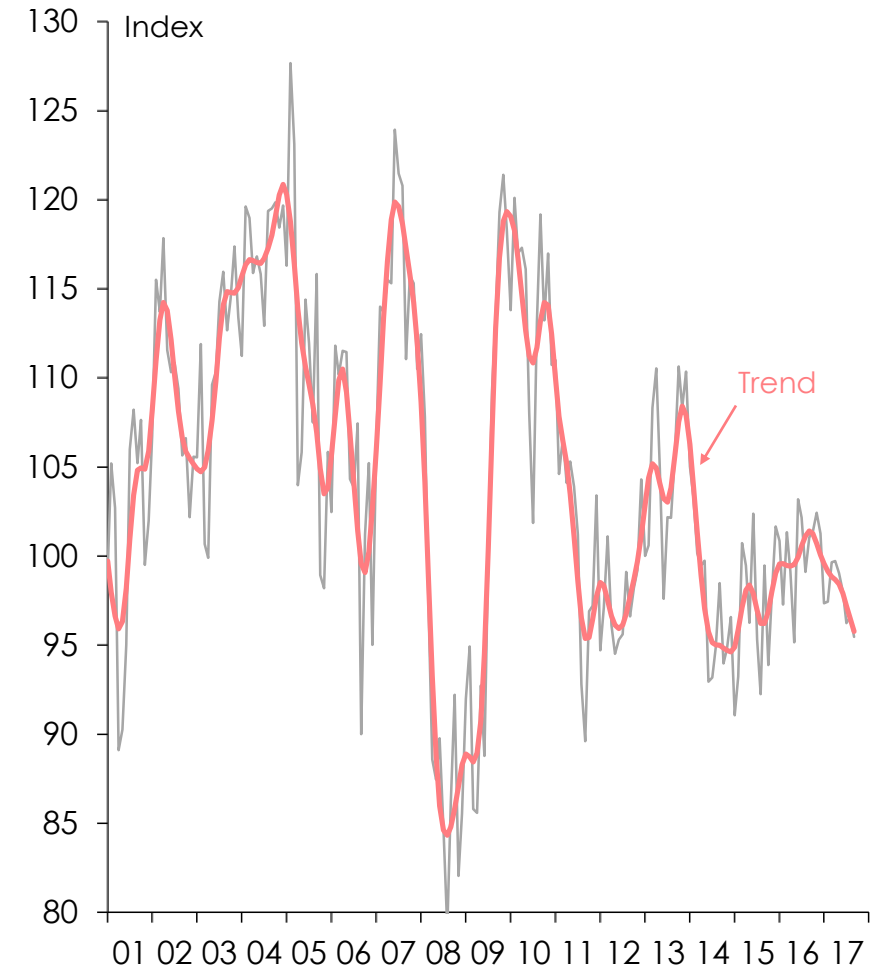
Nominal and real wages



Real household disposable income



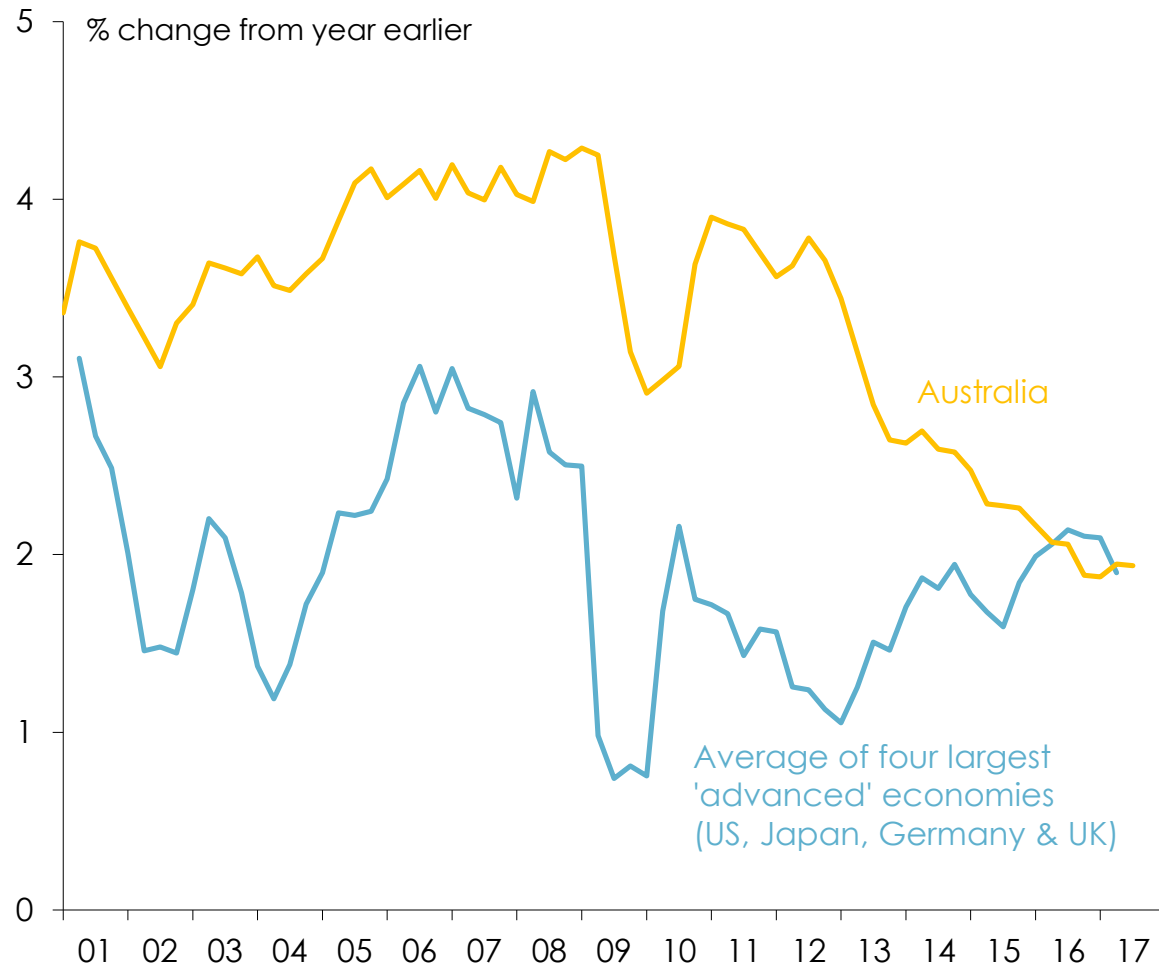
Consumer confidence



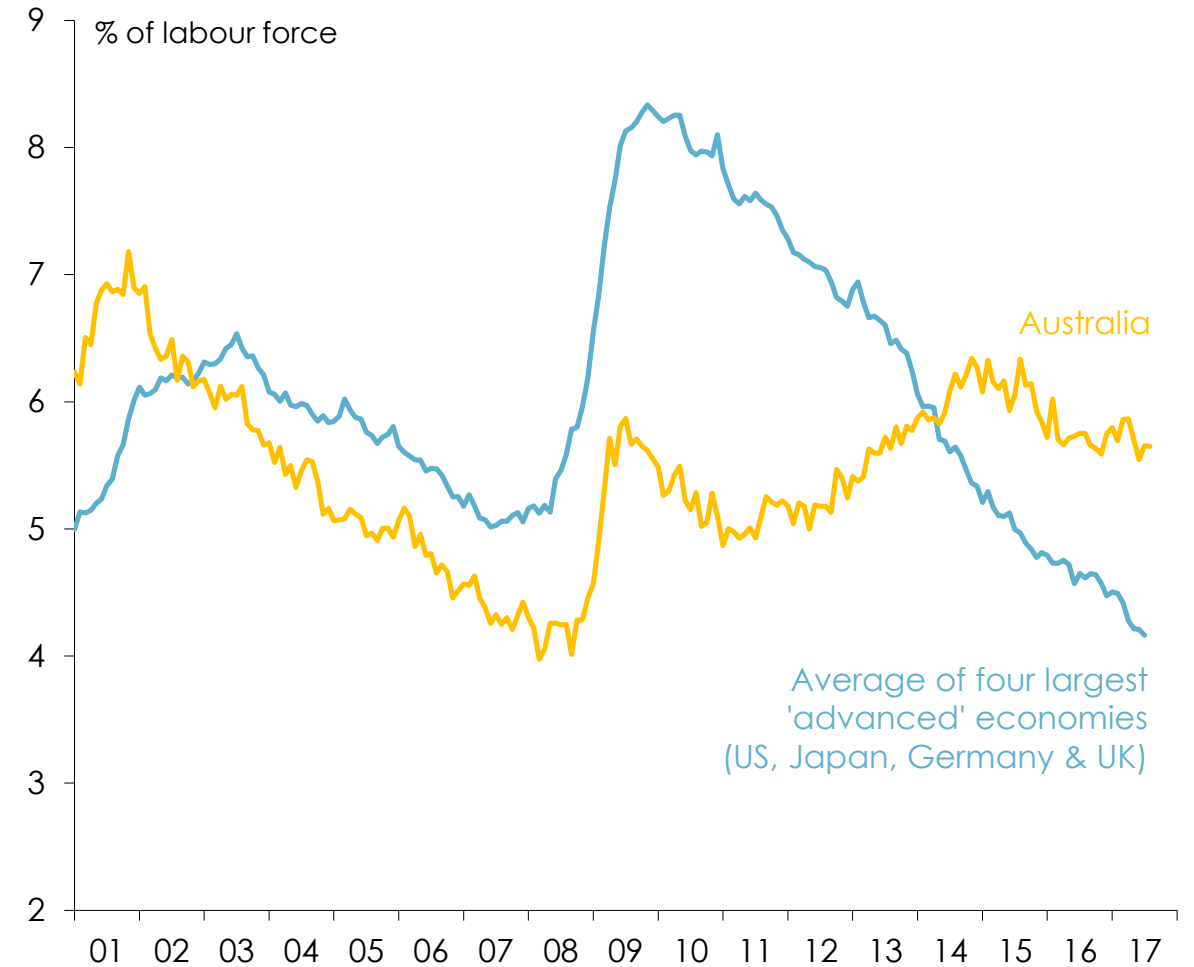
Sources: ABS ; Westpac and Melbourne Institute of Applied Economic & Social Research.

Weak wages growth has been common among 'advanced' economies, especially following periods of high unemployment

Wages growth – Australia vs four largest 'advanced' economies



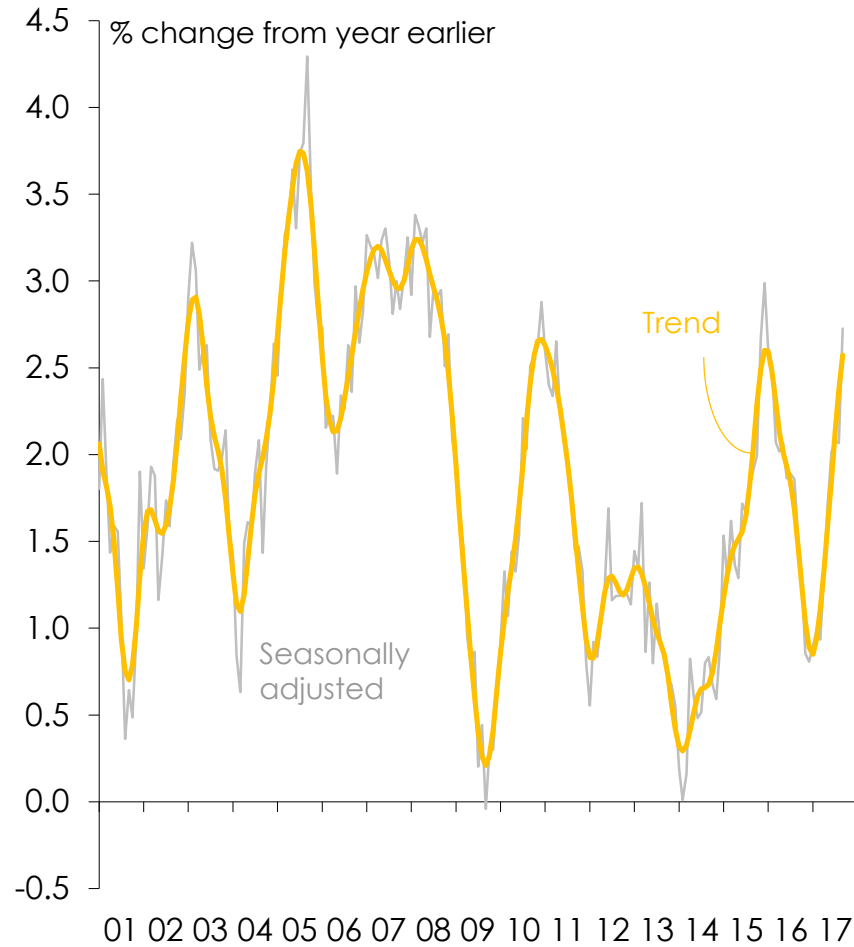
Unemployment – Australia vs four largest 'advanced' economies



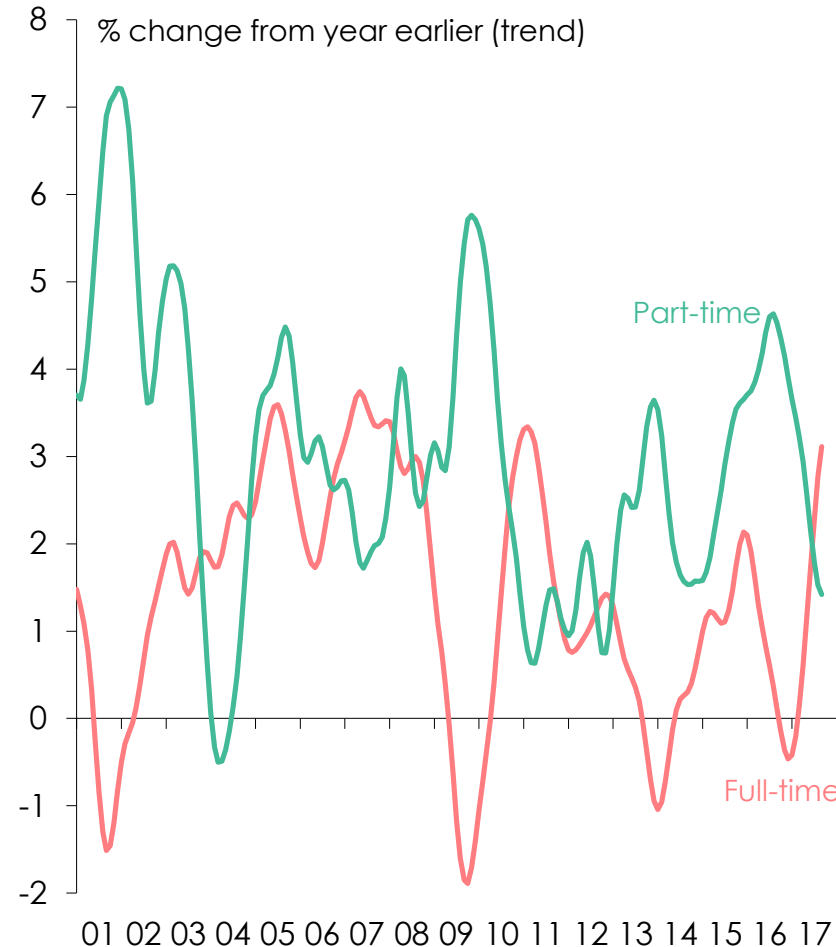
Sources: US Bureau of Labor Statistics; Japan Ministry of Health, Labour & Welfare; Deutsche Bundesbank; UK Office for National Statistics; Australian Bureau of Statistics.

Employment growth has picked up this year – this time led by full-time employment – and seems likely to be sustained

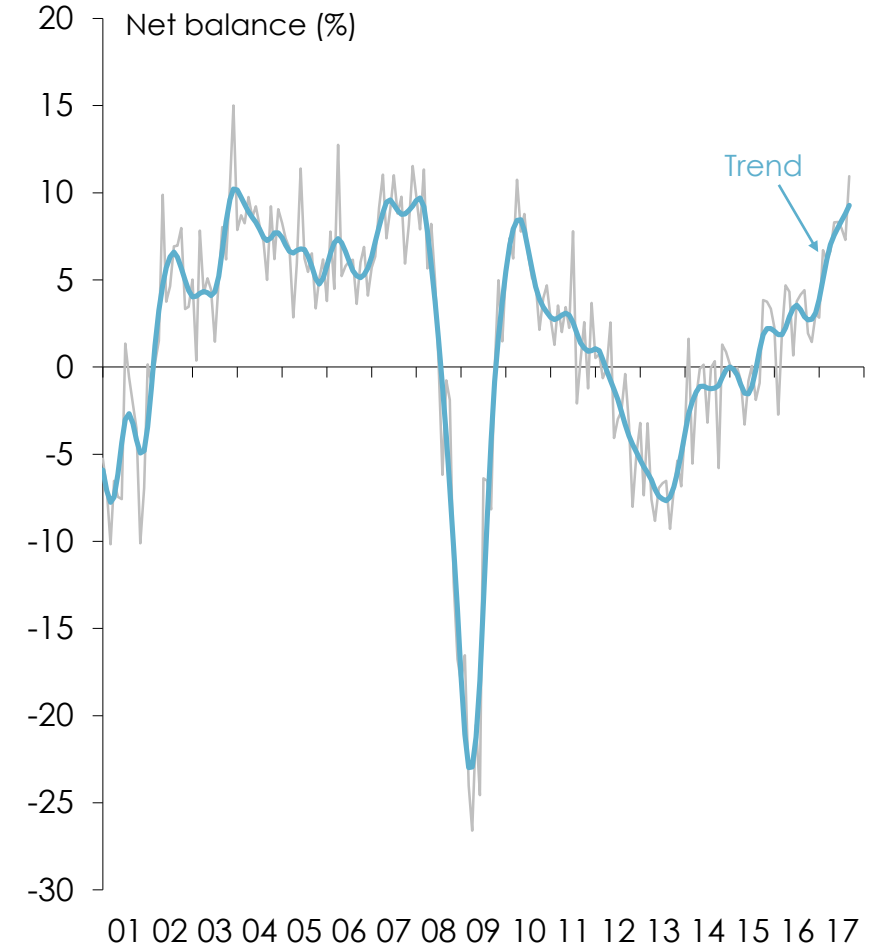
Employment growth



Full-time vs part-time employment



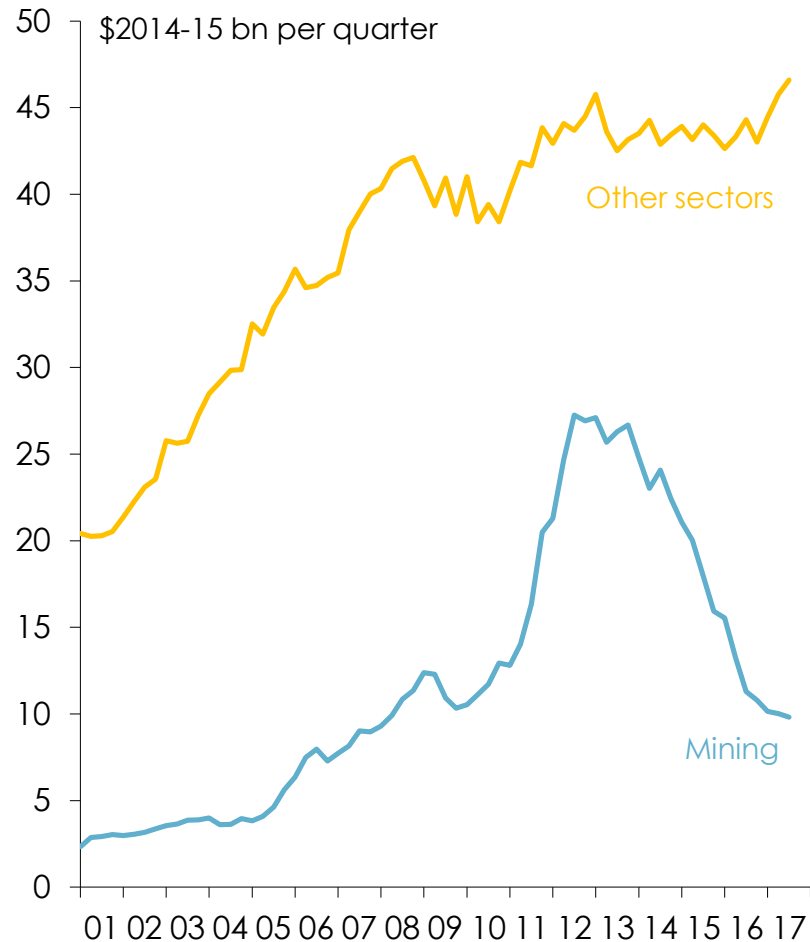
NAB business survey – employer hiring intentions



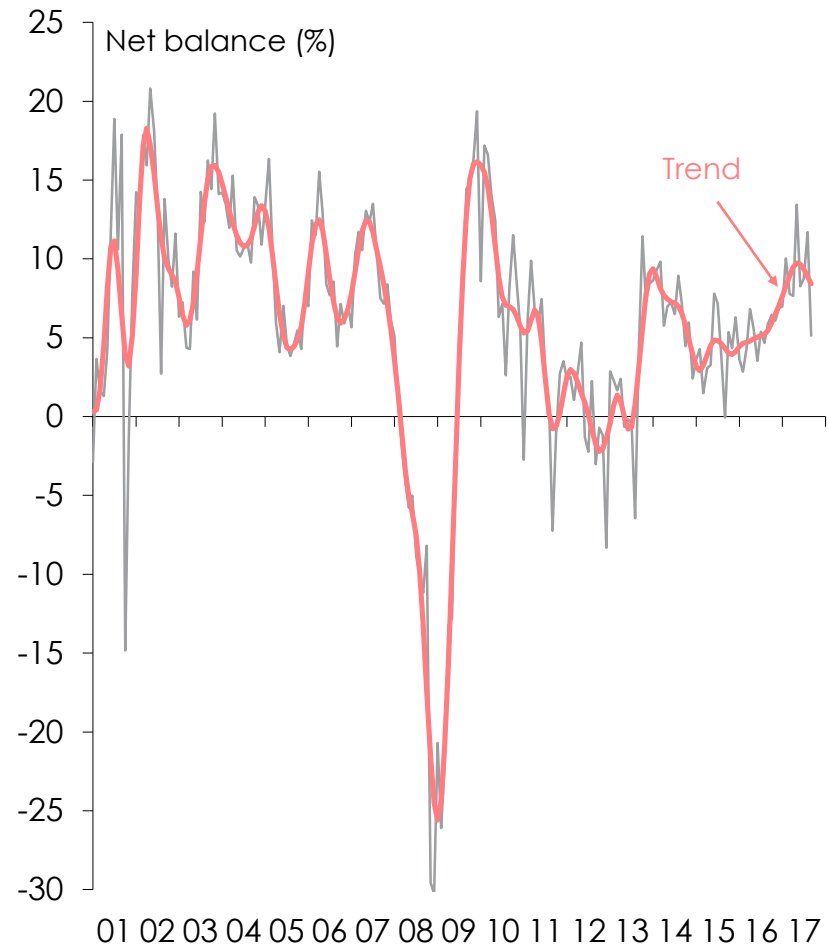
Sources: ABS; National Australia Bank.

Similarly it seems likely that business investment will 'bottom out' and start to pick up over the next year

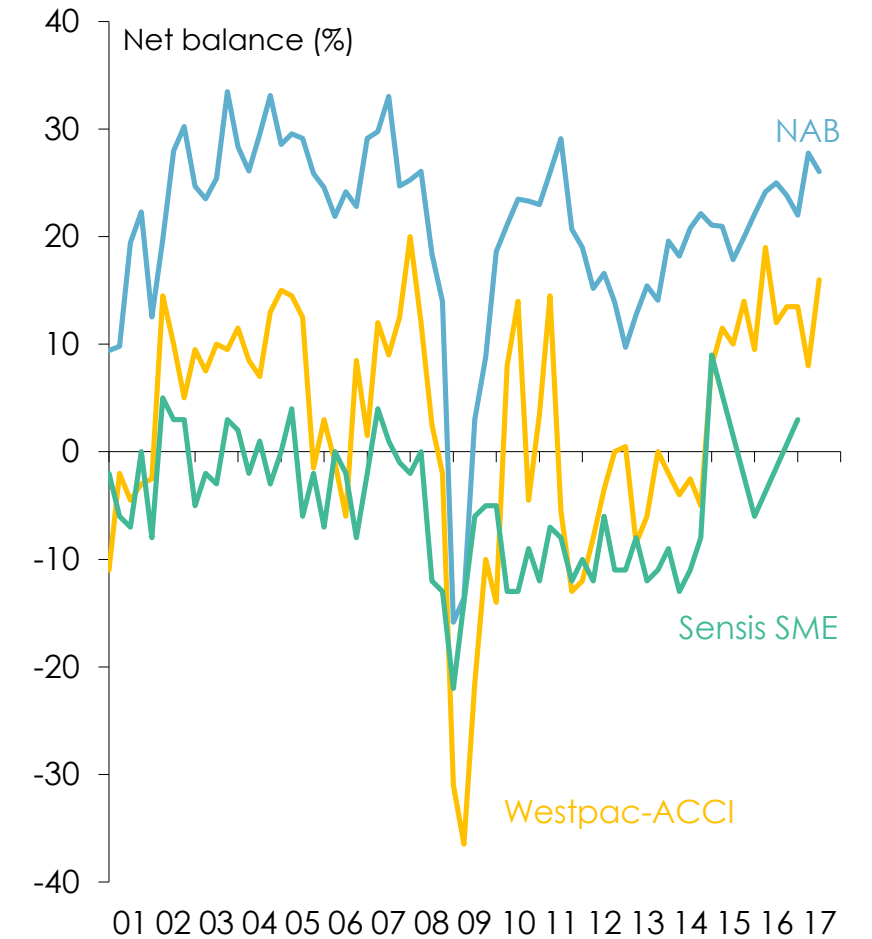
Business investment – mining vs other sectors



Business confidence



Business survey capital expenditure expectations

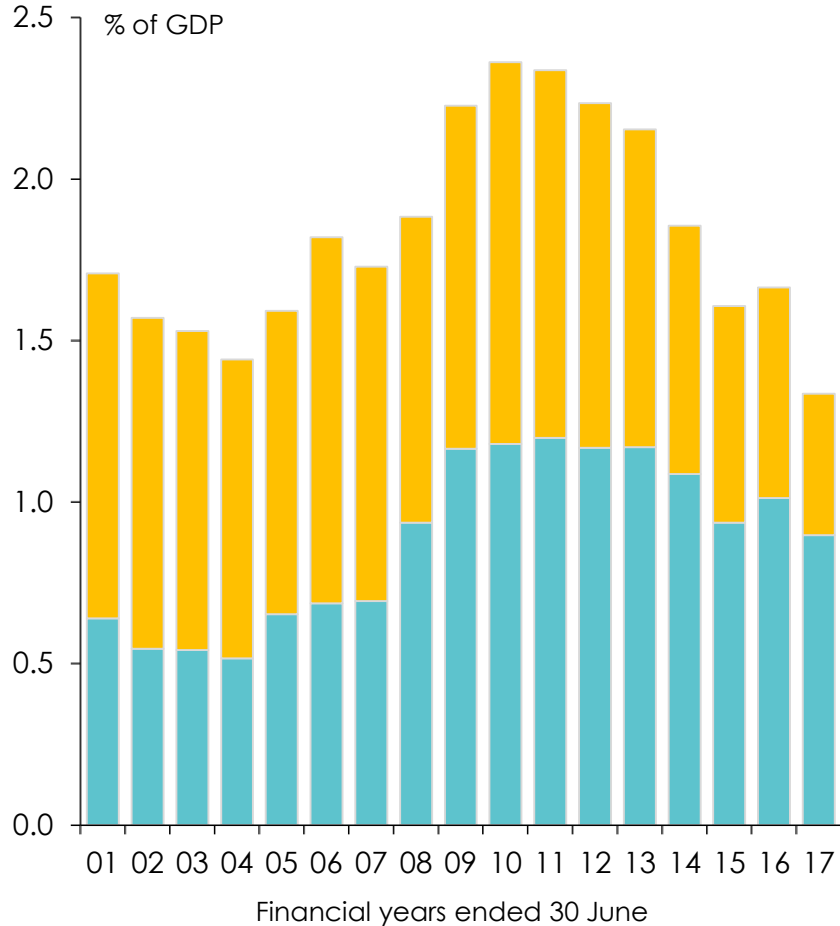


Sources: National Australia Bank; Westpac and Australian Chamber of Commerce & Industry; Sensis.

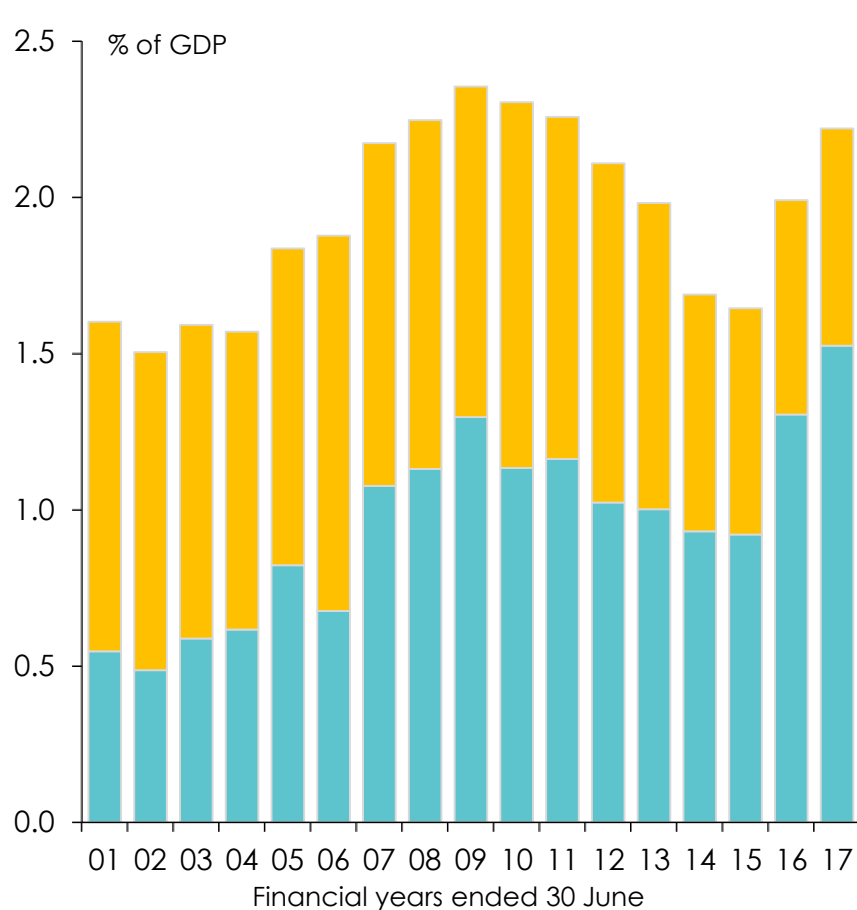
Higher levels of infrastructure investment spending will also provide some impetus to economic growth

Indicators of engineering construction activity for the public sector

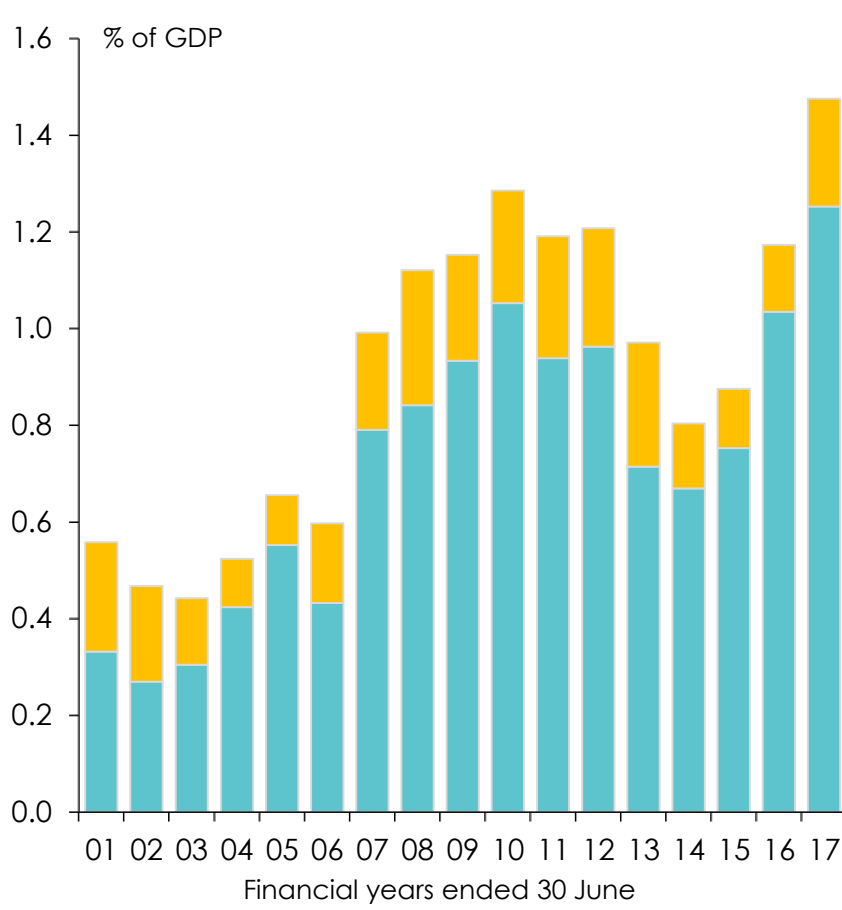
Value of work done



Commencements



Work yet to be done



■ Work by the private sector for the public sector
 ■ Work by the public sector for the public sector

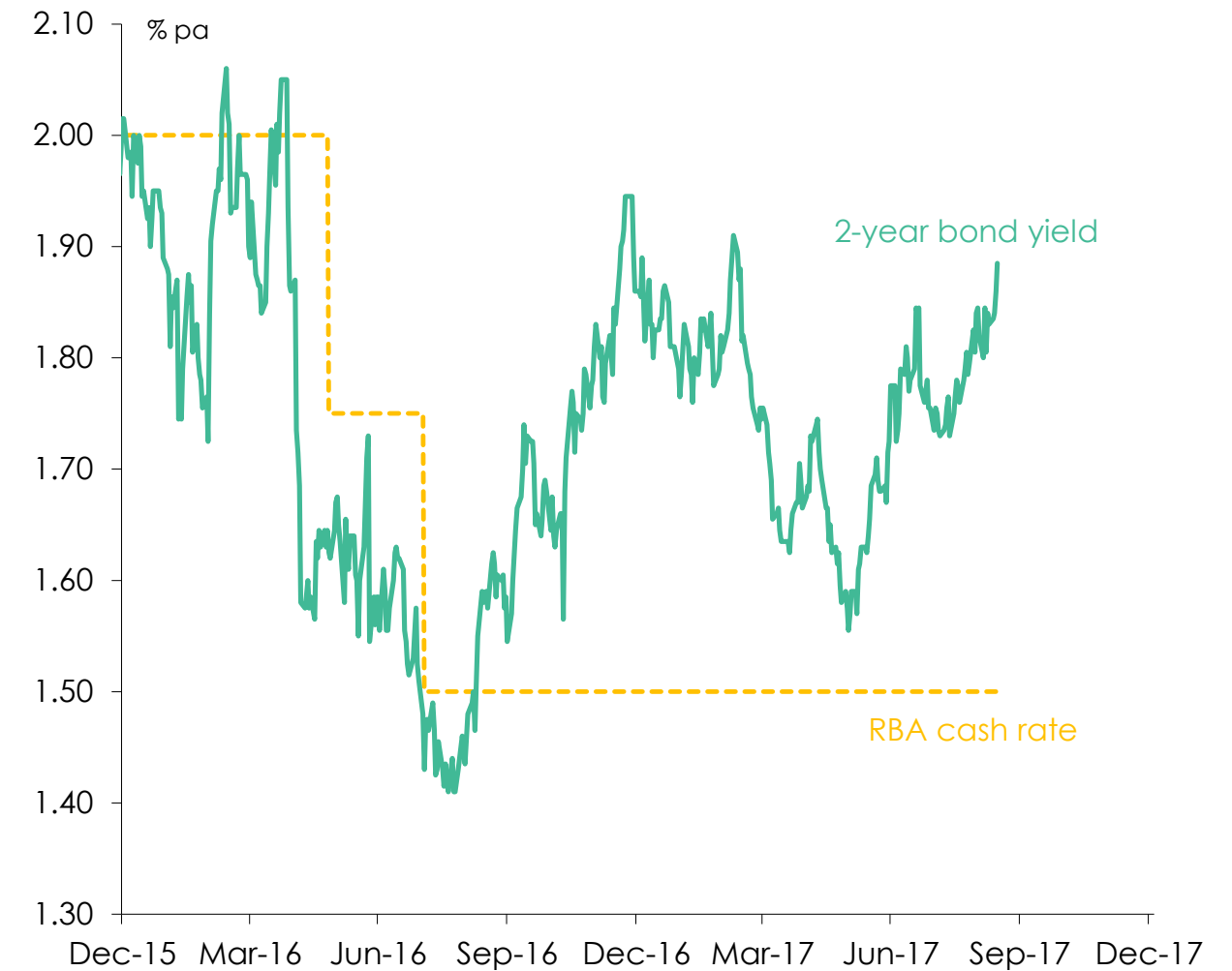
Note: 2016-17 figures for commencements and work yet to be done are for the first three quarters. Source: ABS.

The RBA will probably start raising rates in the first half of next year – but slowly, and not by very much in total

Overnight index swap (OIS) rates and the Reserve Bank cash rate



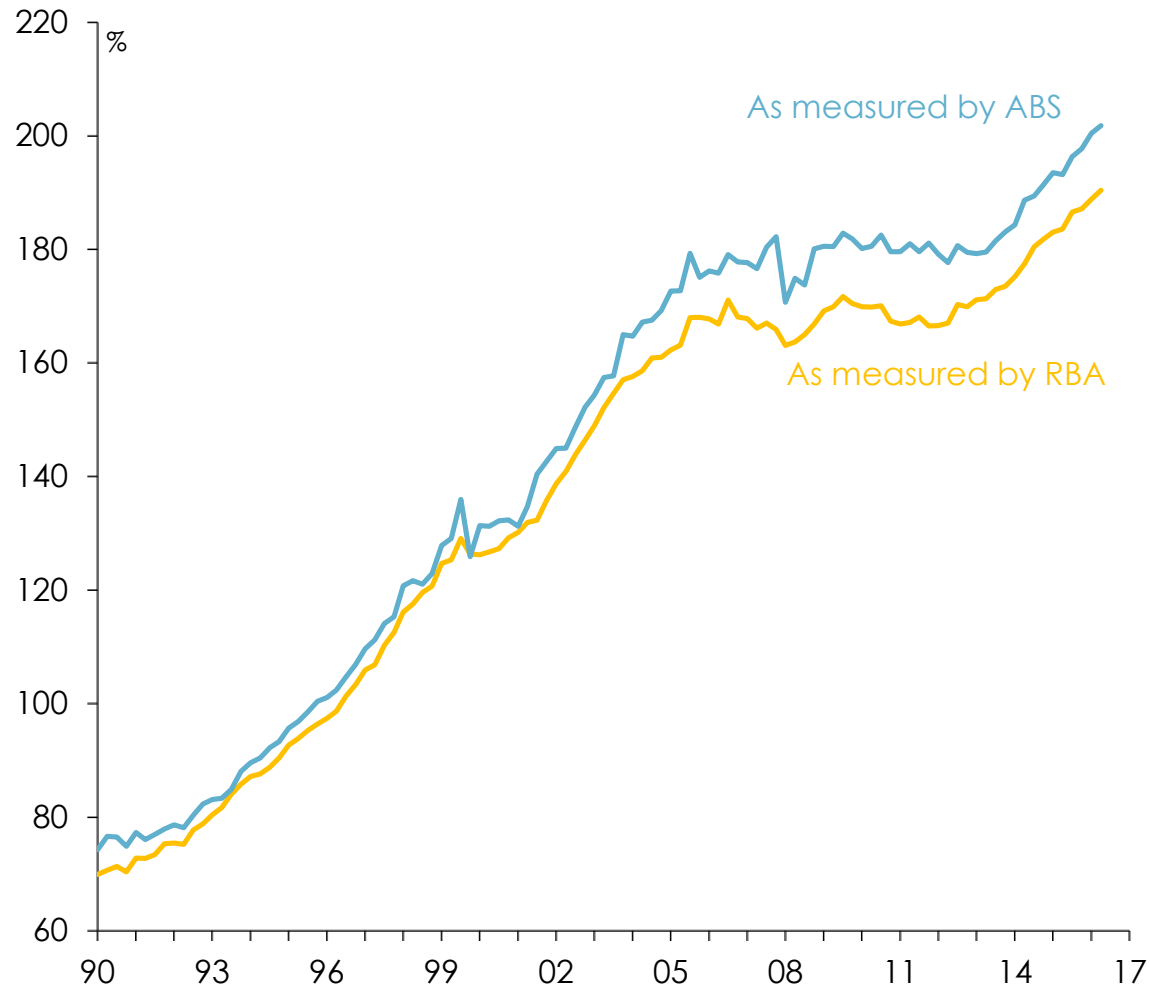
2-year Commonwealth bond yields and the Reserve Bank cash rate



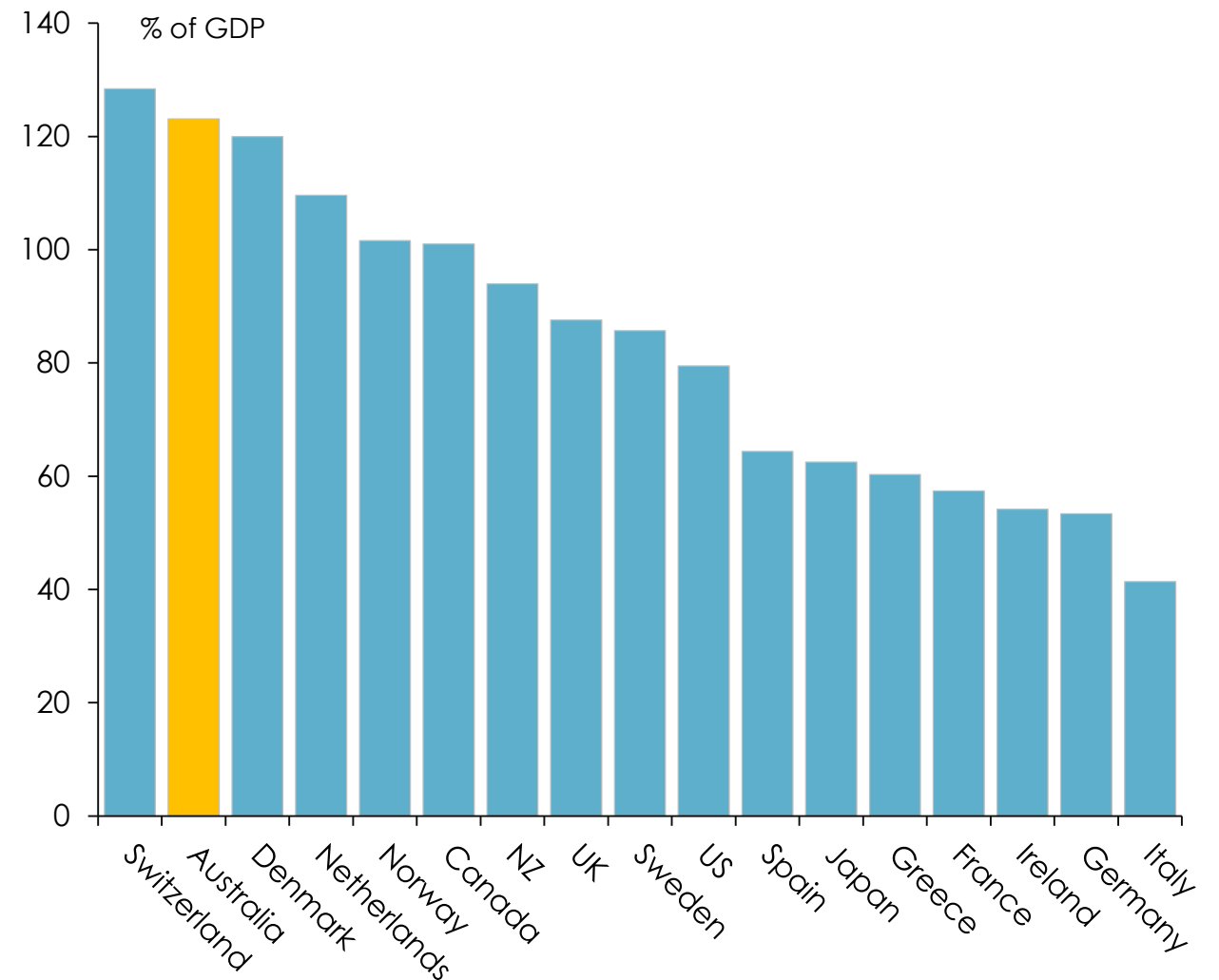
Source: Reserve Bank of Australia; Thomson Reuters Datastream.

Australian household debt rose rapidly from 1990 through 2007, and again since 2012 – to one of the highest levels in the ‘developed’ world

Australian household debt-to-income ratio



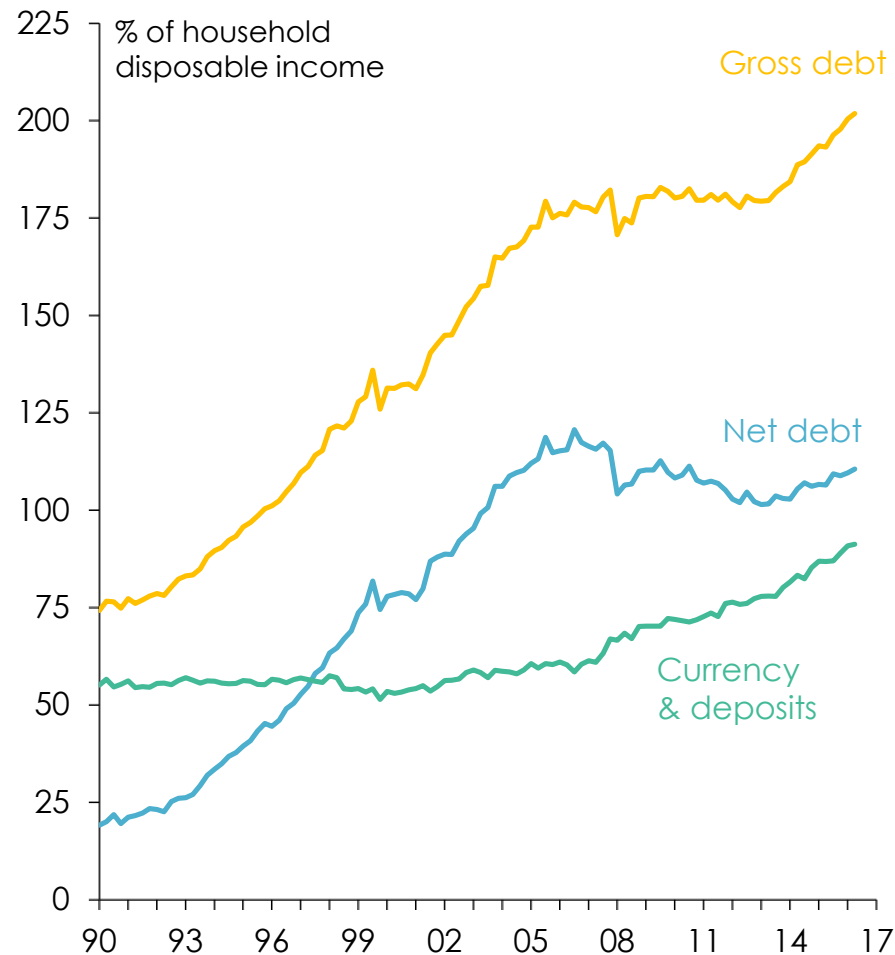
Household debt-to-GDP ratios, ‘advanced’ economies, March 2017



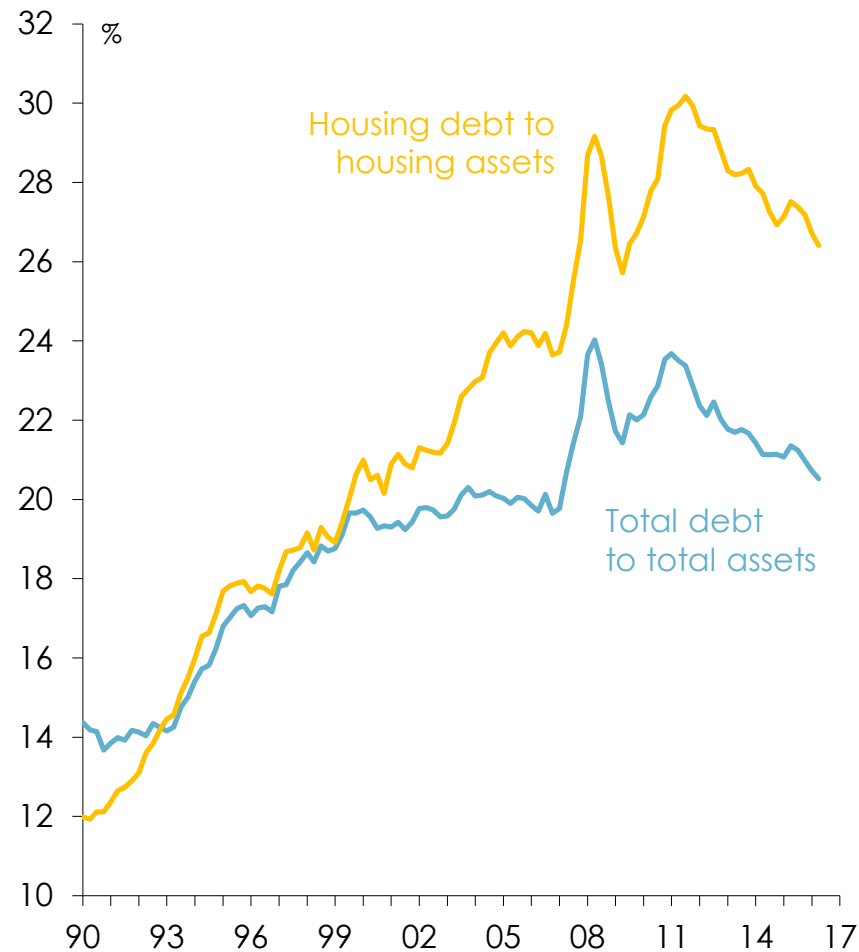
Sources: Australian Bureau of Statistics; Reserve Bank of Australia ; Bank for International Settlements (Basel, Switzerland).

However the level of household debt shouldn't be seen independently of the level of liquid assets, other assets or debt servicing capacity

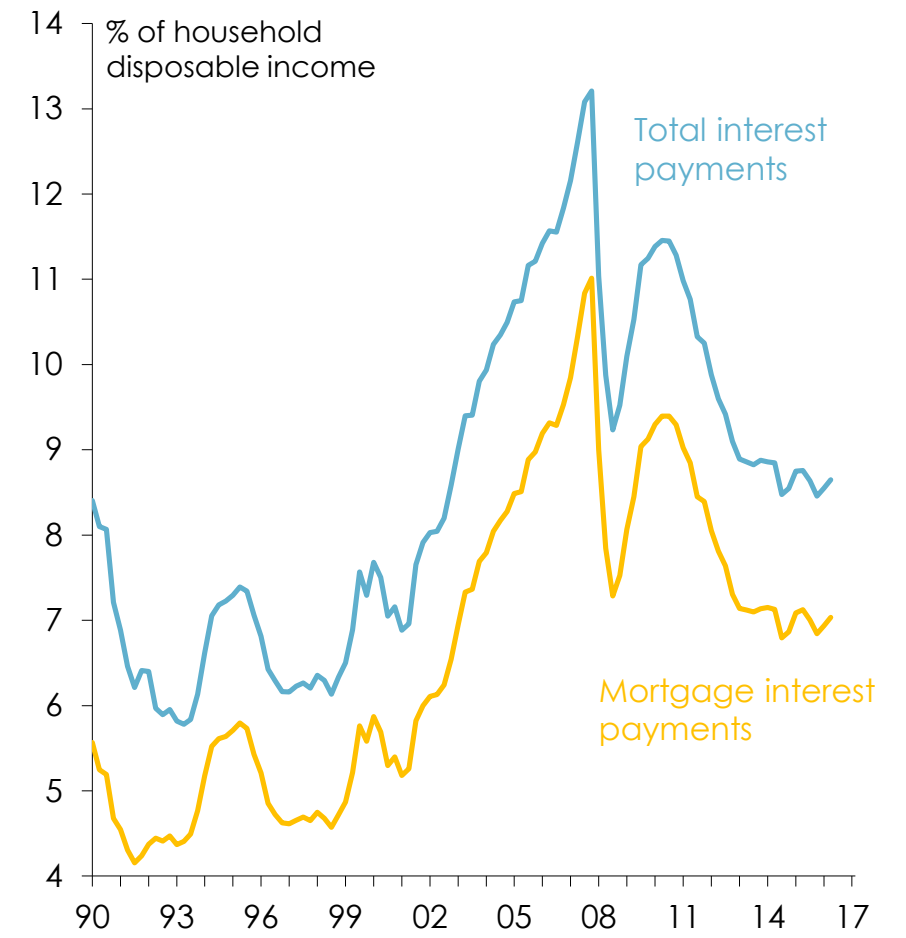
Household gross debt, liquid assets and net debt



Household debt-to-assets ratio



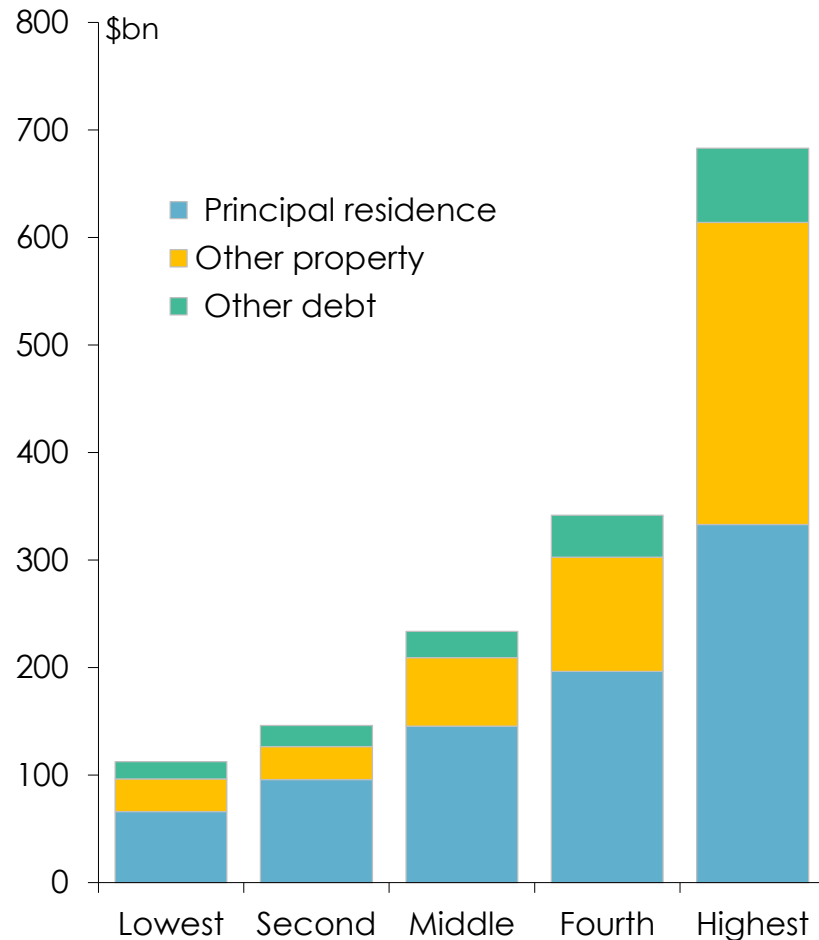
Household interest-to-income ratio



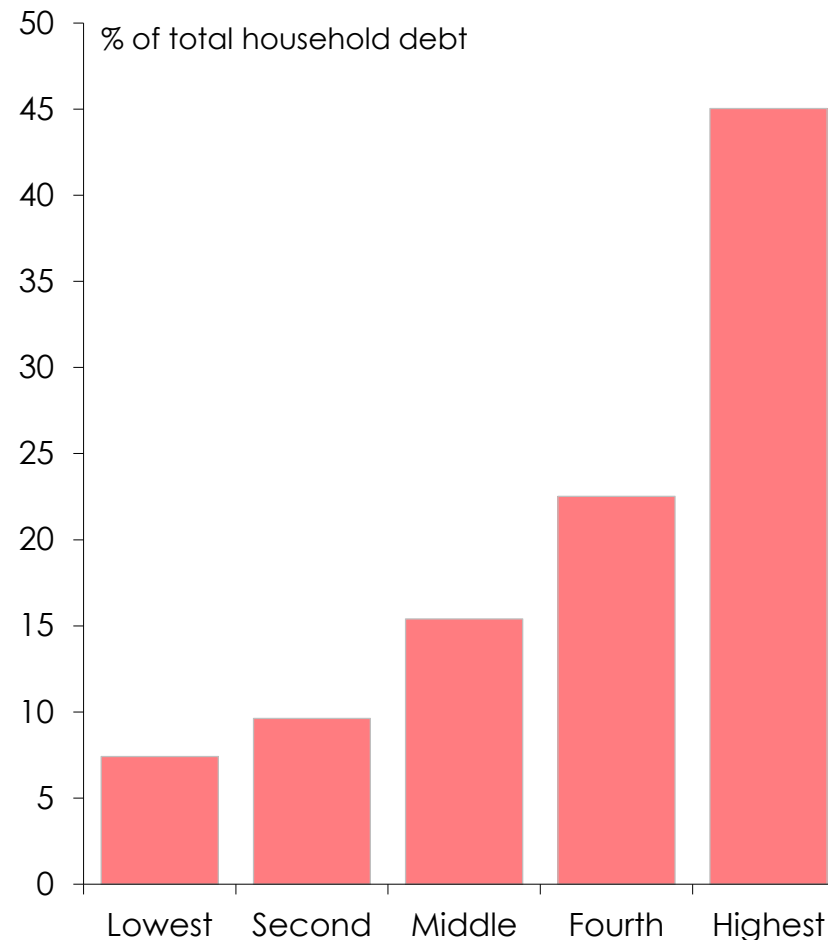
Sources: ABS, RBA.

Two-thirds of Australian household debt is owed by the richest 40% of households – and that has barely changed over the past dozen years

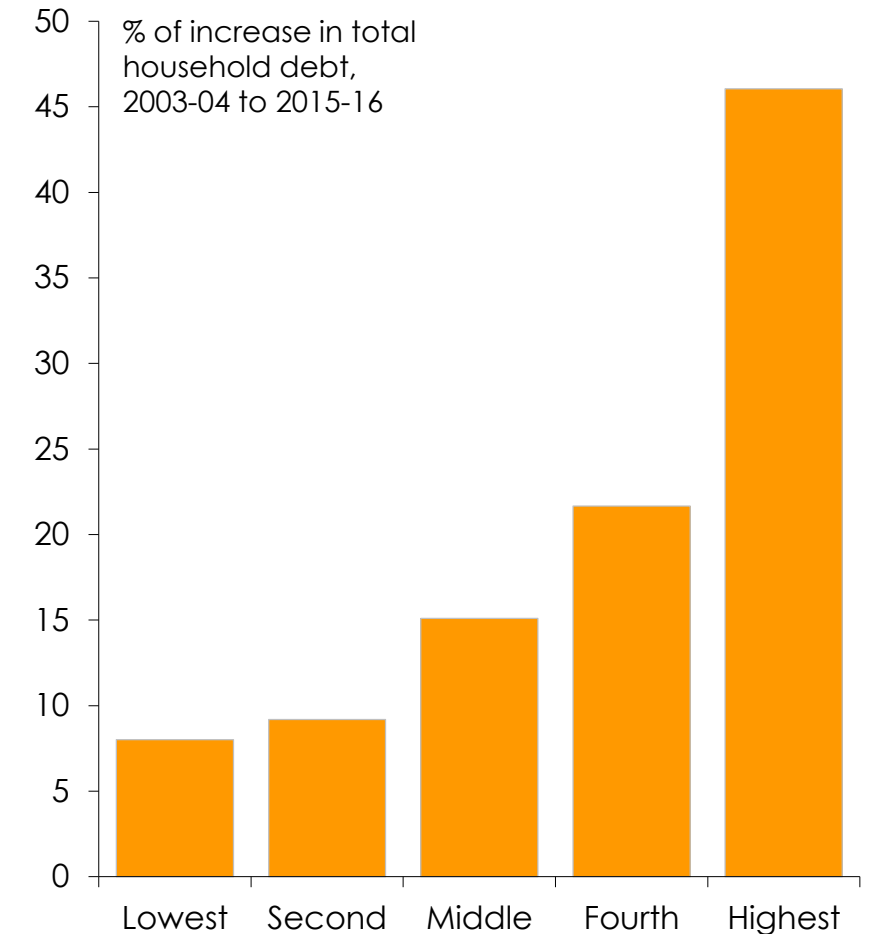
Household debt by income quintile, 2015-16



Share of total debt by income quintile, 2015-16



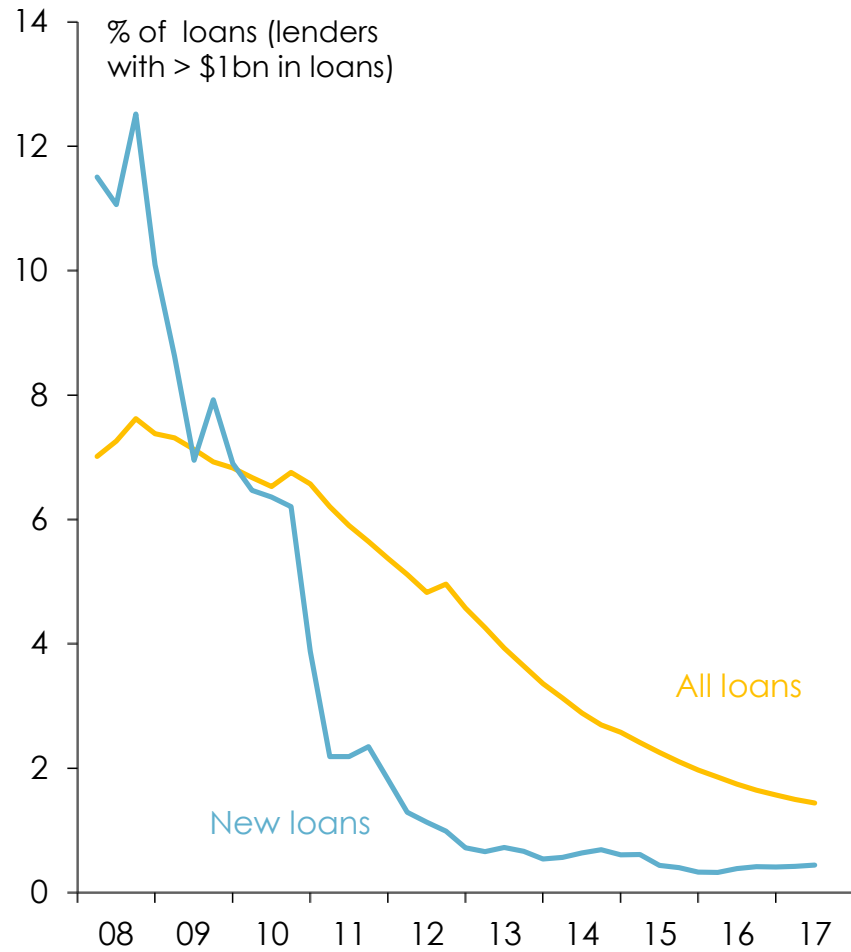
Share of increase in debt by quintile, 2003-04 to 2015-16



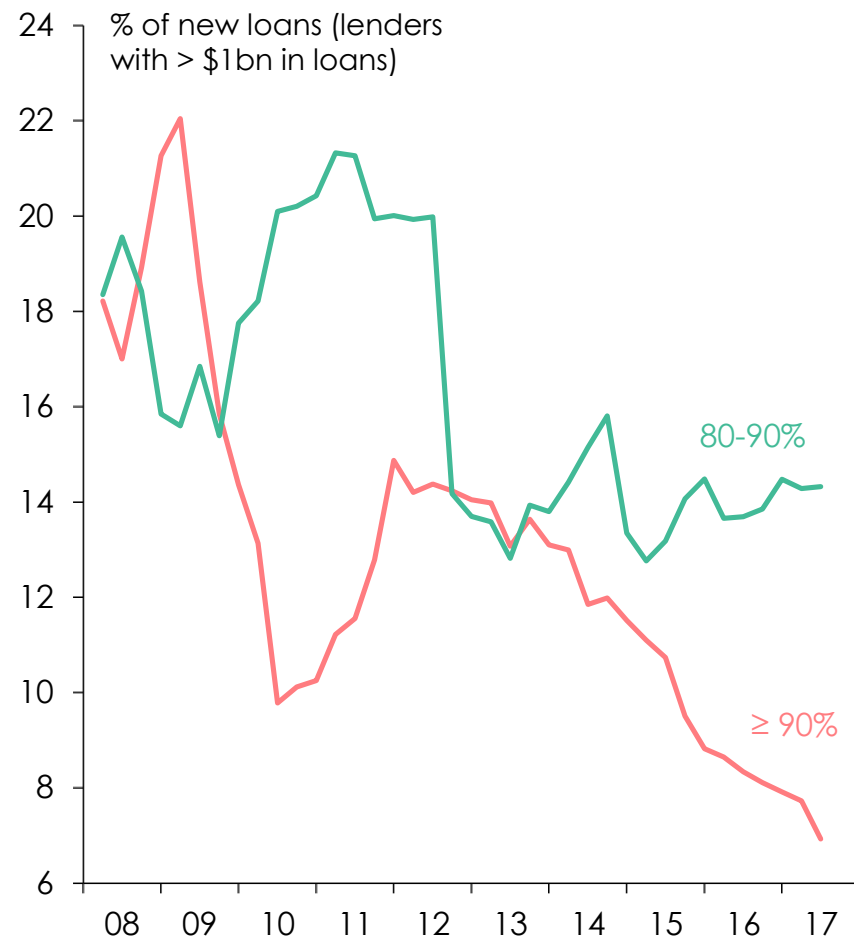
Source: ABS.

Most of the riskier forms of lending have been curtailed since the GFC – except for interest-only loans which APRA has only recently acted on

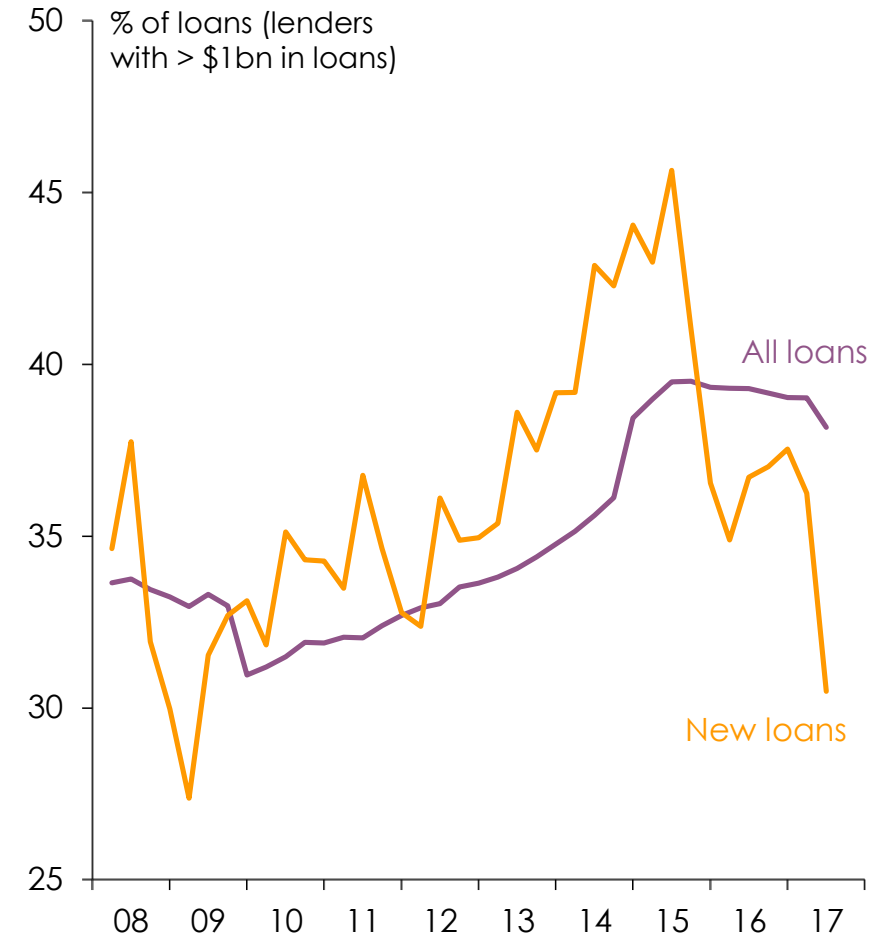
Low-doc loans as a pc of total mortgages



High LVR loans as a pc of new mortgages



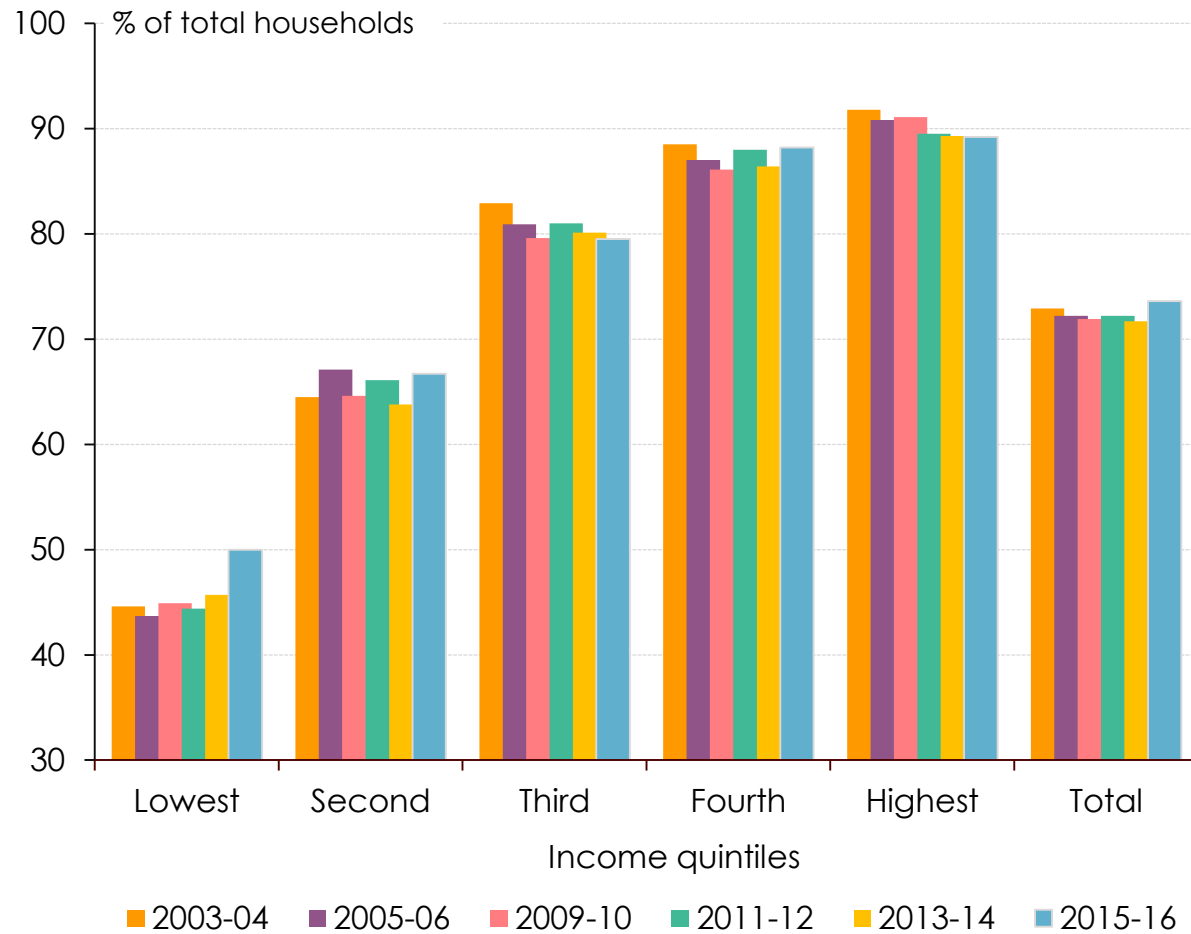
Interest-only loans as a pc of mortgages



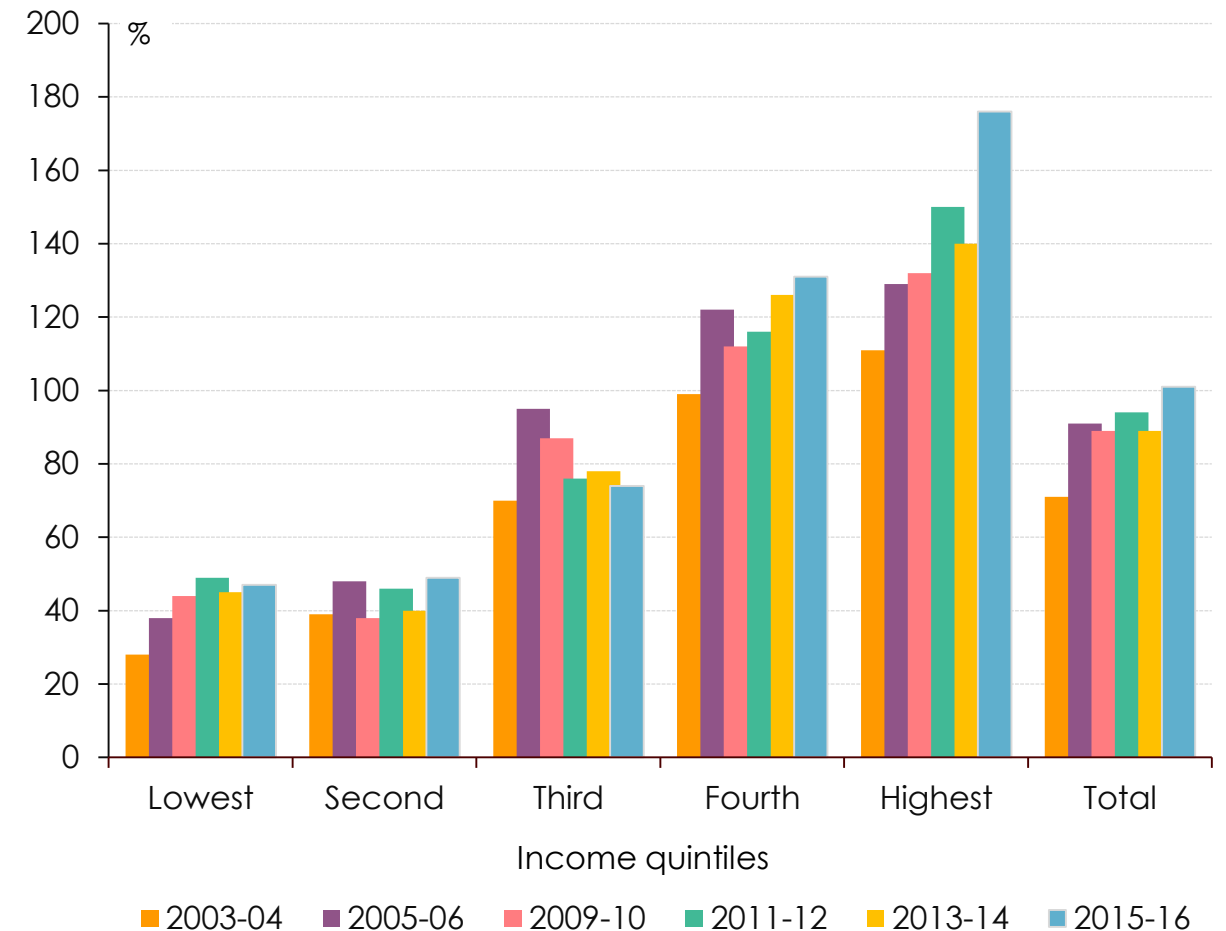
Source: Australian Prudential Regulation Authority.

The proportion of households who have debt hasn't changed much over the past decade – but those who do have debt have a lot more of it

Proportion of households with debt, by disposable income quintile



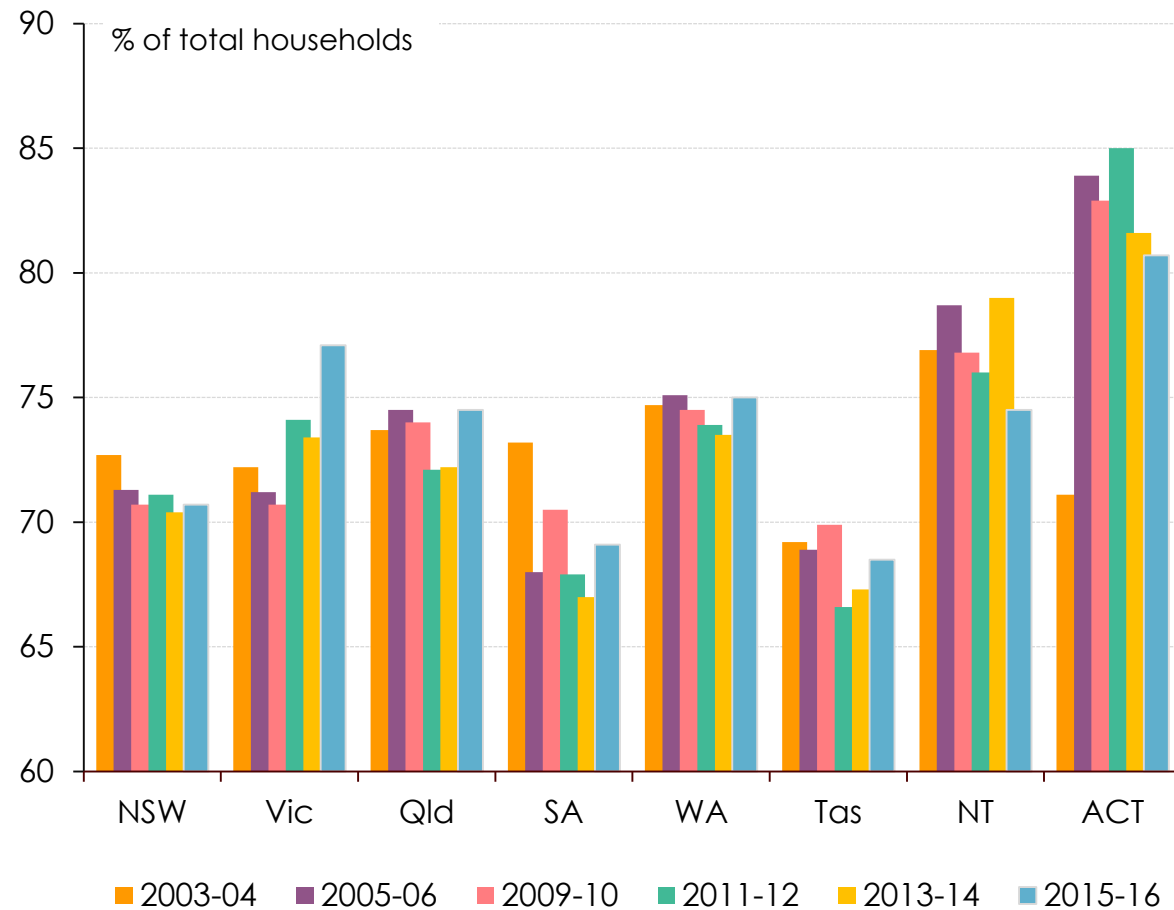
Median debt-to-income ratio, by disposable income quintile



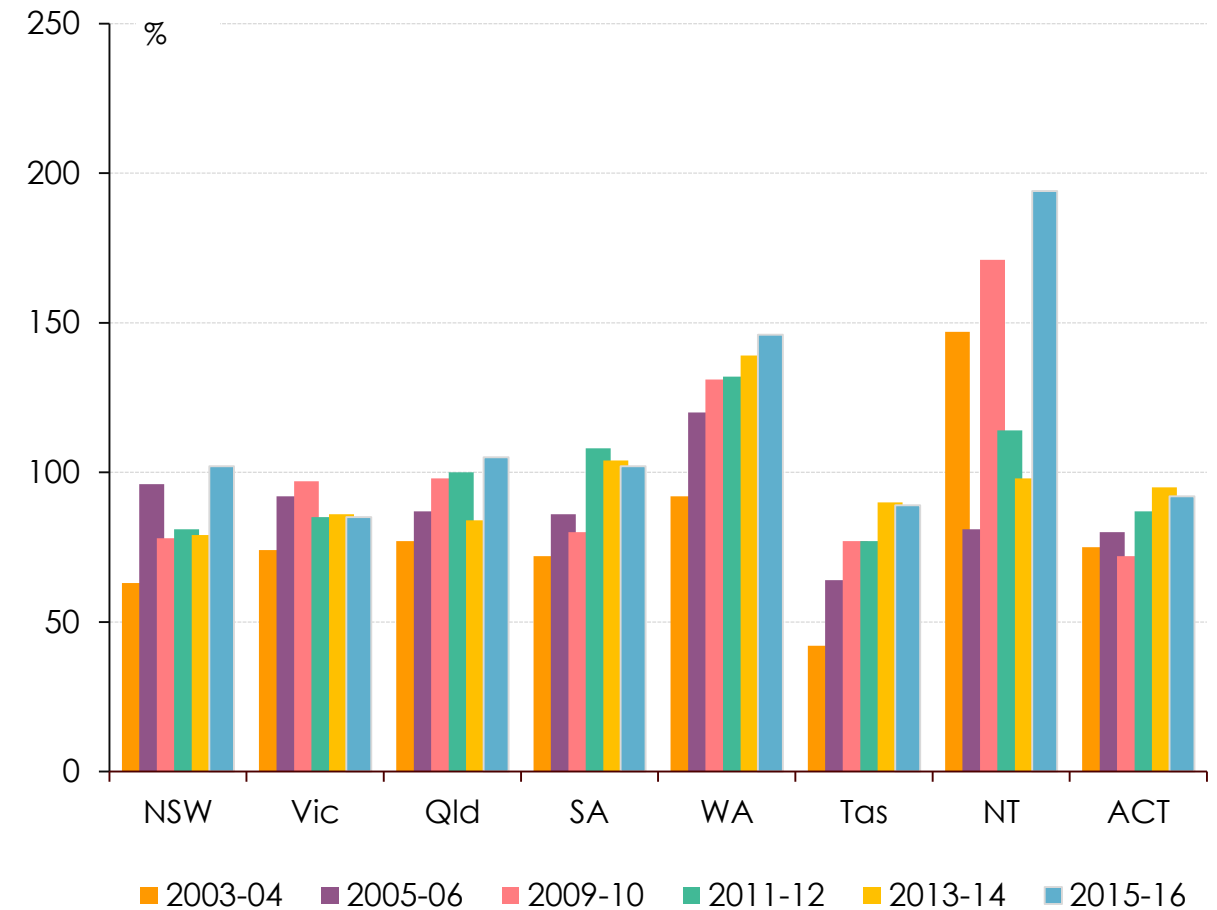
Sources: Australian Bureau of Statistics, *Household Income and Wealth 2015-16* (6523.0).

Proportion of households with debt has risen most in Victoria and Qld – but average amount of debt has risen most in NSW, WA & NT

Proportion of households with debt, by State and Territory



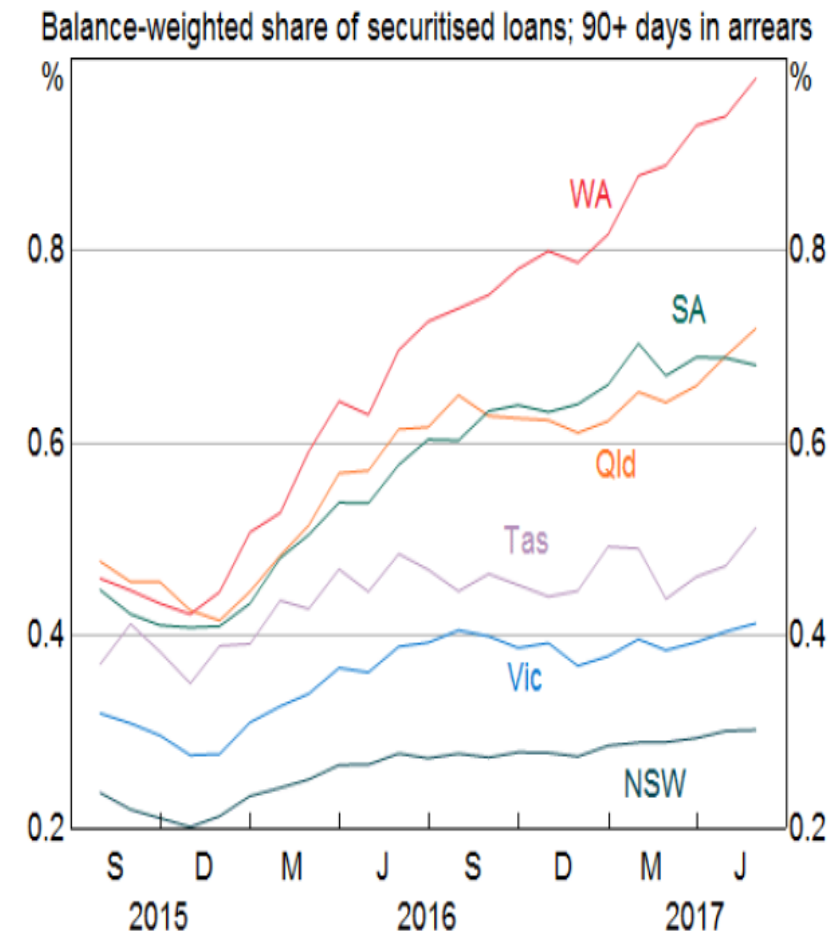
Median debt-to-income ratio, by State and Territory



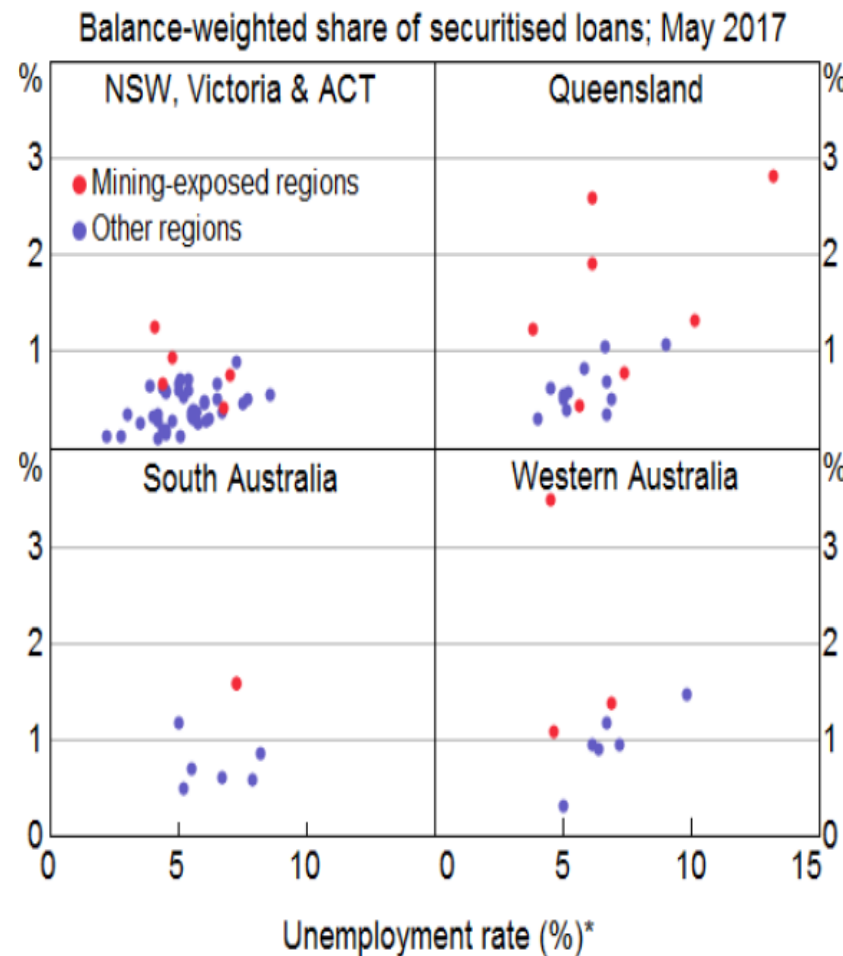
Sources: Australian Bureau of Statistics, Household Income and Wealth 2015-16 (6523.0).

Other data also points to larger increase in mortgage arrears in mining-related regions in WA and Queensland

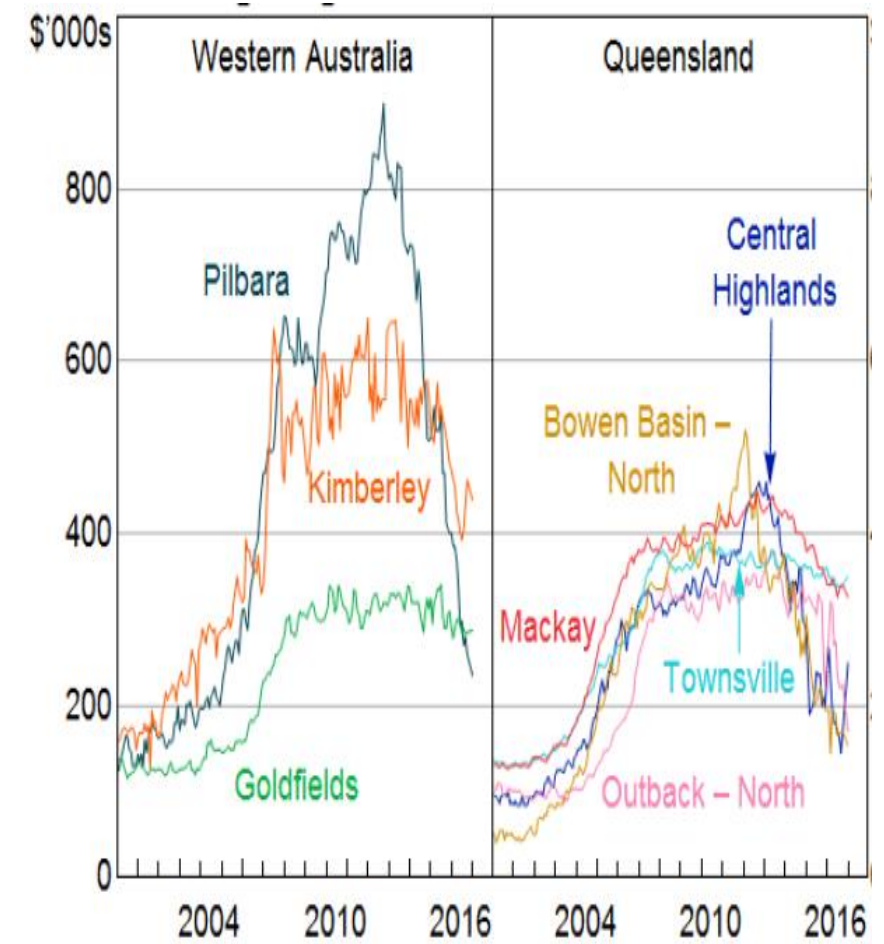
Mortgage arrears on securitized loans, by State



Mortgage arrears and unemployment by region



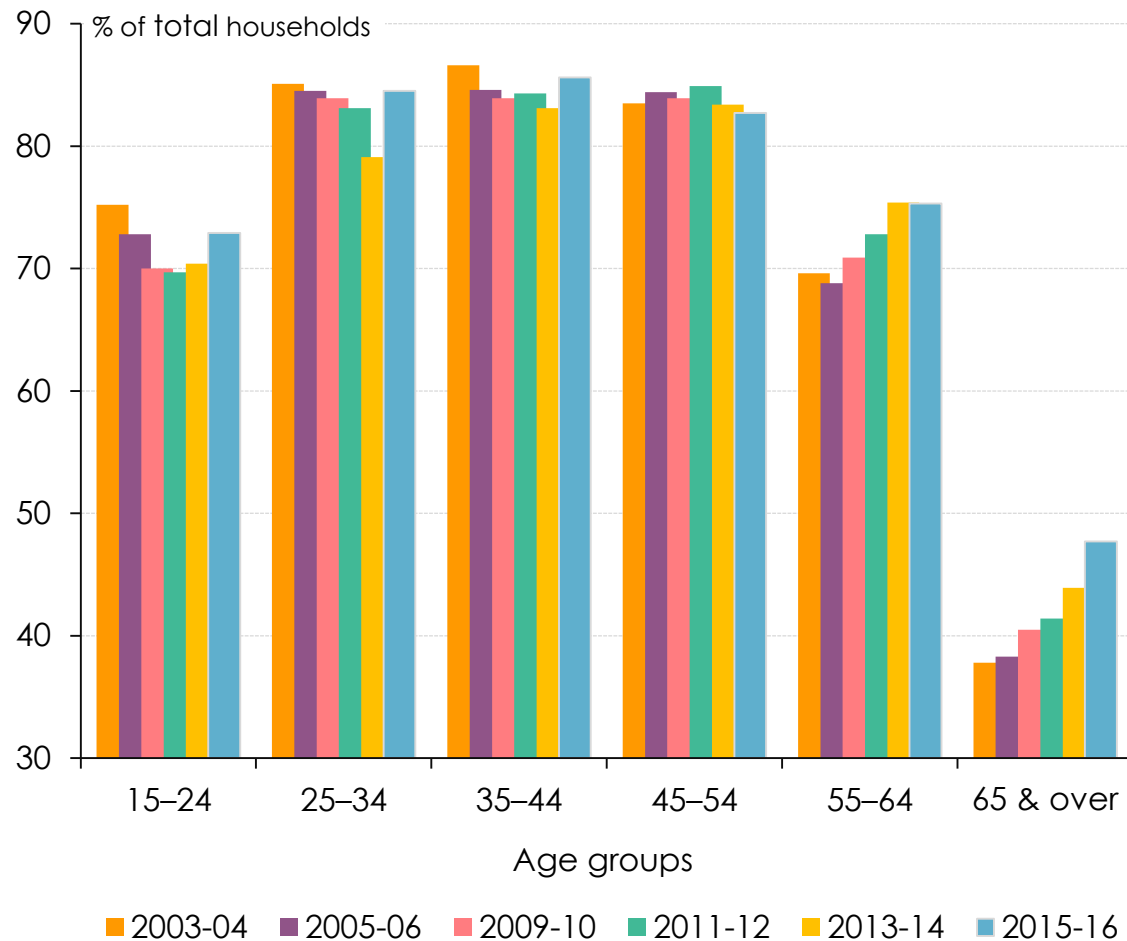
Interest-only loans as a pc of mortgages



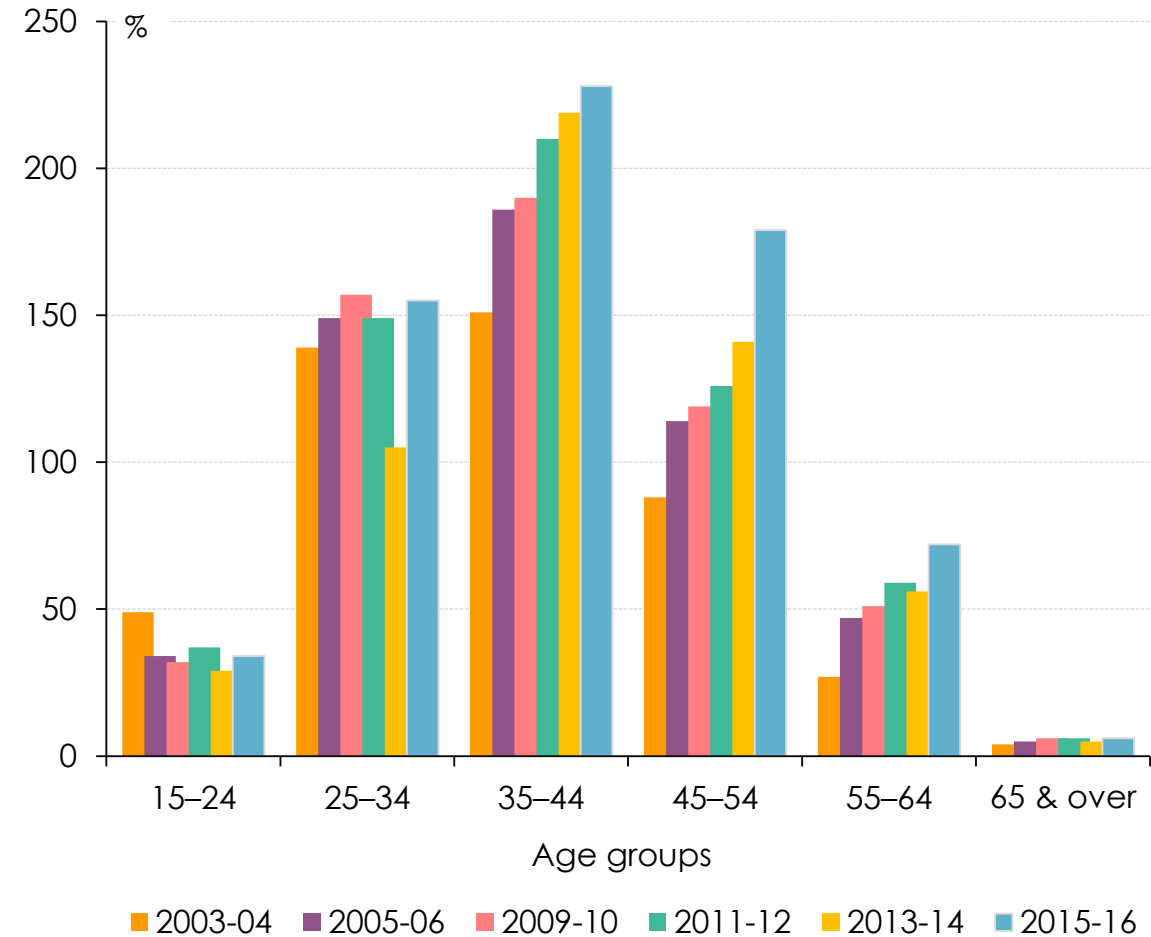
Source: Chris Kent (Assistant Governor Financial Markets, RBA), 'Some Innovative Mortgage Data', Address to Moody's Analytics Australia Conference, 14th August 2017

Older households are more likely to have some debt outstanding than a decade ago – but it's middle-aged households who owe more

Proportion of households with debt, by age group



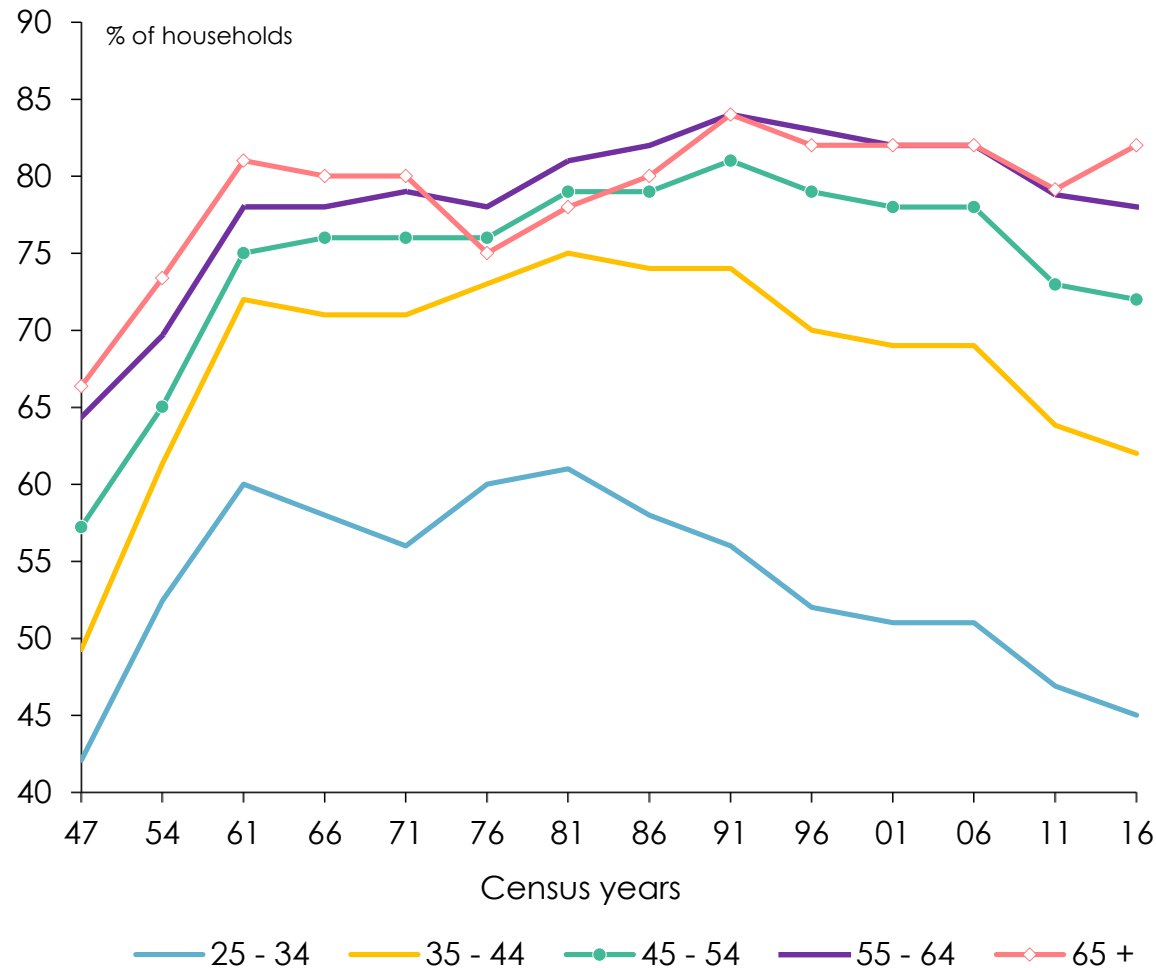
Median debt-to-income ratio, by age group



Sources: Australian Bureau of Statistics, *Household Income and Wealth 2015-16* (6523.0).

Trends in debt by age reflect declining home ownership rates among younger households – and people taking longer to pay off mortgages

Home ownership rates by age group at censuses, 1947-2017



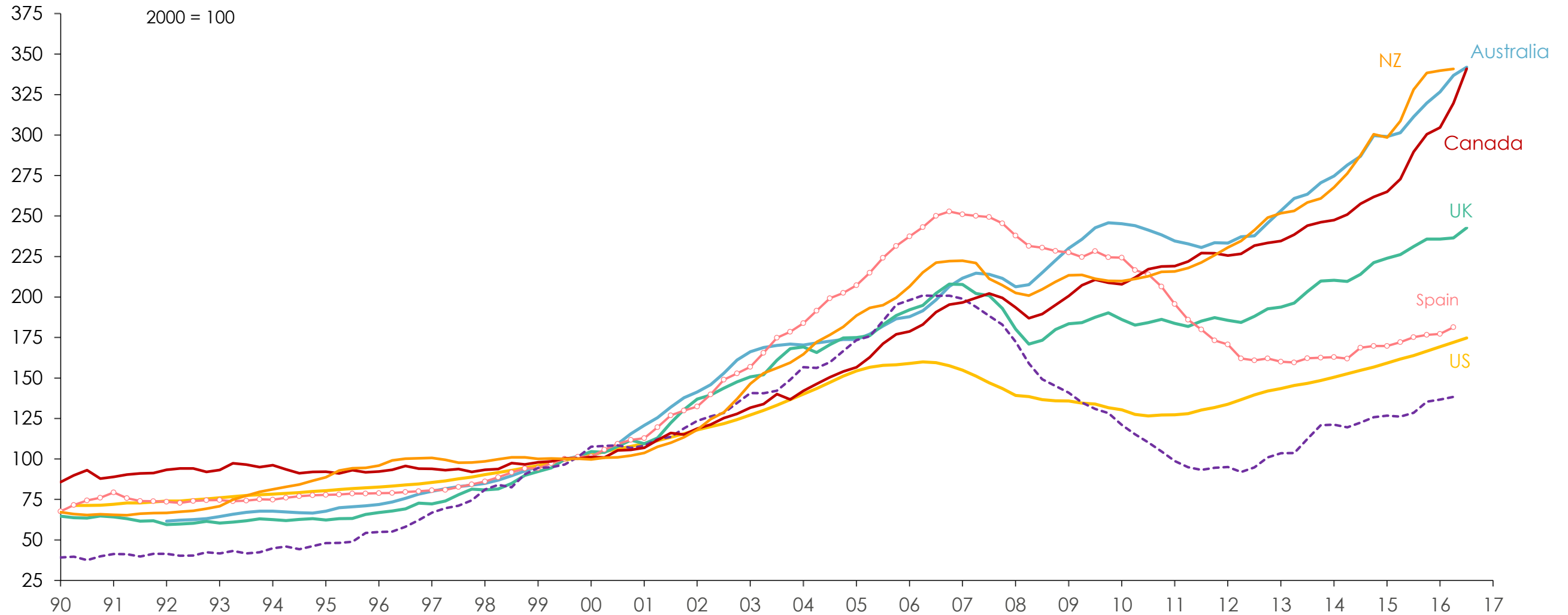
Home owners with mortgage debt outstanding, by age group, 1996-2016



Sources: Judith Yates (University of Sydney; Australian Bureau of Statistics).

The fact that Australian property prices have gone up a lot doesn't mean they must come down like they did in the US, Spain or Ireland

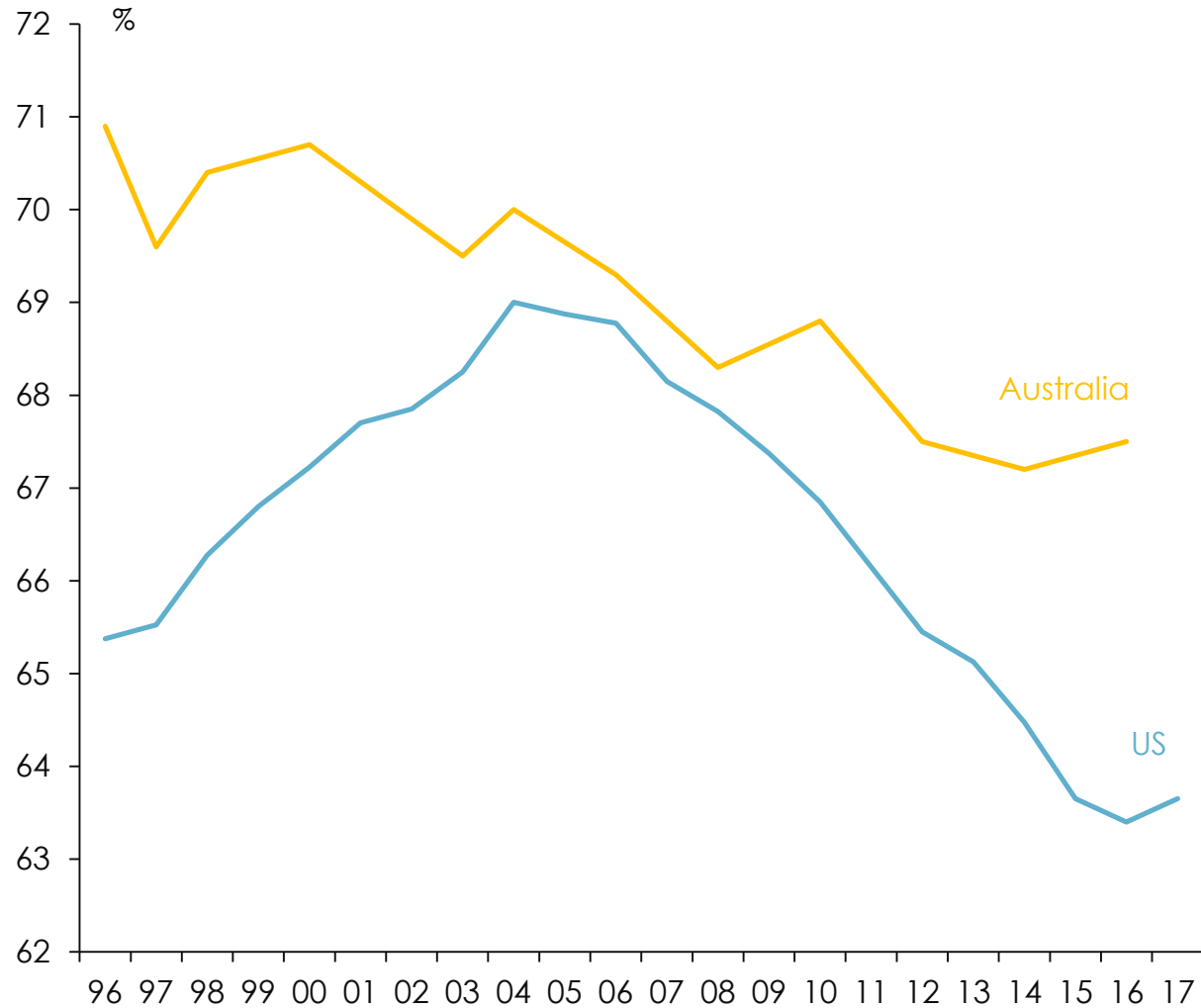
Residential property prices – Australia and other 'advanced' economies



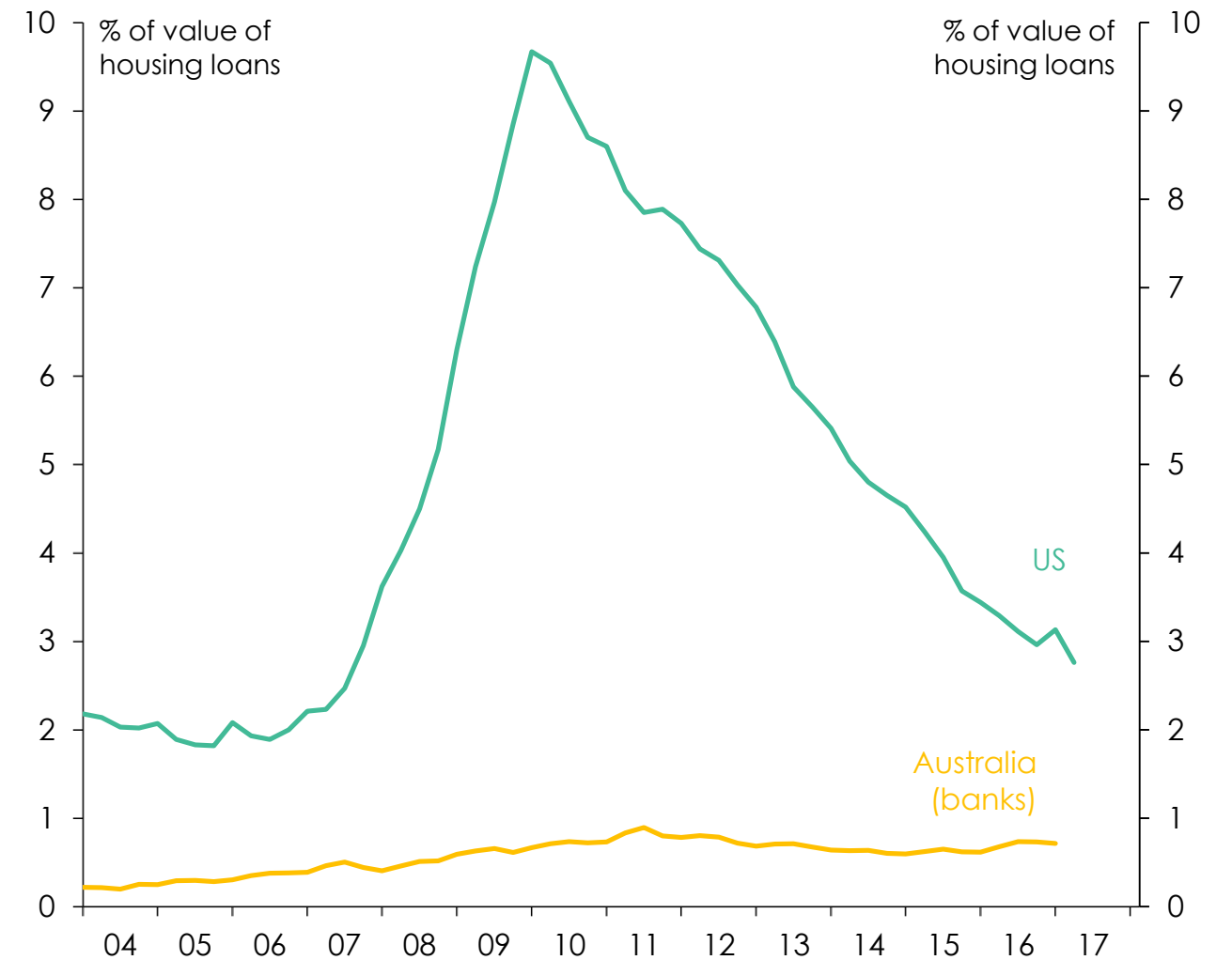
Source: CoreLogic; US Federal Housing Finance Association; Bank for International Settlements.

There's unlikely to be a lot of 'forced sellers' in Australia, as there were in the US

Home ownership rates, US and Australia



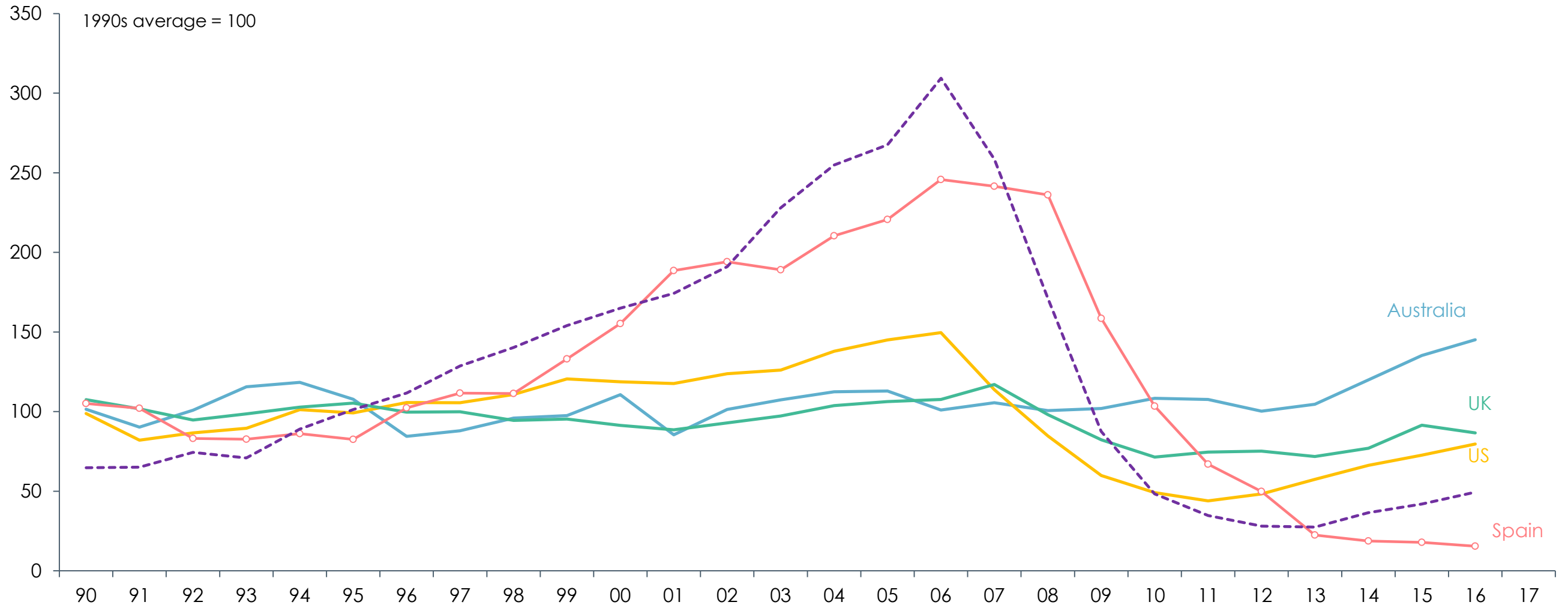
Mortgage delinquency rates, US and Australia



Sources: ABS, US Department of Commerce; Reserve Bank of Australia; Mortgage Bankers' Association of America.

... and they're less likely to be selling into an 'over-supplied' market than in the US, Spain or Ireland a decade ago

Dwelling completions – Australia and other 'advanced' economies



Sources: Australian Bureau of Statistics; US Commerce Department; UK Office of National Statistics; Instituto Nacional de Estadística d'España; Ireland Central Statistics Office

Summary

- ❑ **Interest rates aren't going any lower, despite below-trend growth, below-target inflation, higher-than-desired unemployment (and under-employment), and a surprisingly strong A\$**
 - the RBA believes that cutting rates further in present circumstances would only result in more household debt, higher property prices and more risks
 - they are saving what little 'ammunition' they have left for any unforeseen shocks
- ❑ **Nor, however, is the Reserve Bank in any hurry to start raising interest rates**
 - for precisely the same reasons (growth, inflation, unemployment, currency)
- ❑ **When the Reserve Bank does start to raise rates – probably some time around the middle of next year – it will move cautiously and gradually**
 - and it will not raise rates back to levels that were previously thought of as 'normal'
- ❑ **Australian households do now have a lot of debt – by both historical and international standards**
 - but over two-thirds of that debt is owed by high-income households
 - Australian households also have (at least in aggregate) a lot of assets, both liquid and 'real'
- ❑ **Most of the increase in debt over the past decade or so has been among older households**
 - reflecting the fact that people are taking much longer to pay off their (much larger) mortgages
- ❑ **There are clearly pockets of vulnerability among Australian household borrowers**
 - for example. Households with large interest-only loans, or borrowers in regions affected by the mining boom and bust
- ❑ **But the probability of a housing price and debt 'meltdown' in Australia of the type experienced a decade ago in the US, Ireland or Spain remains very small**
 - given differences in borrower and lender behaviour, and in housing supply and demand