

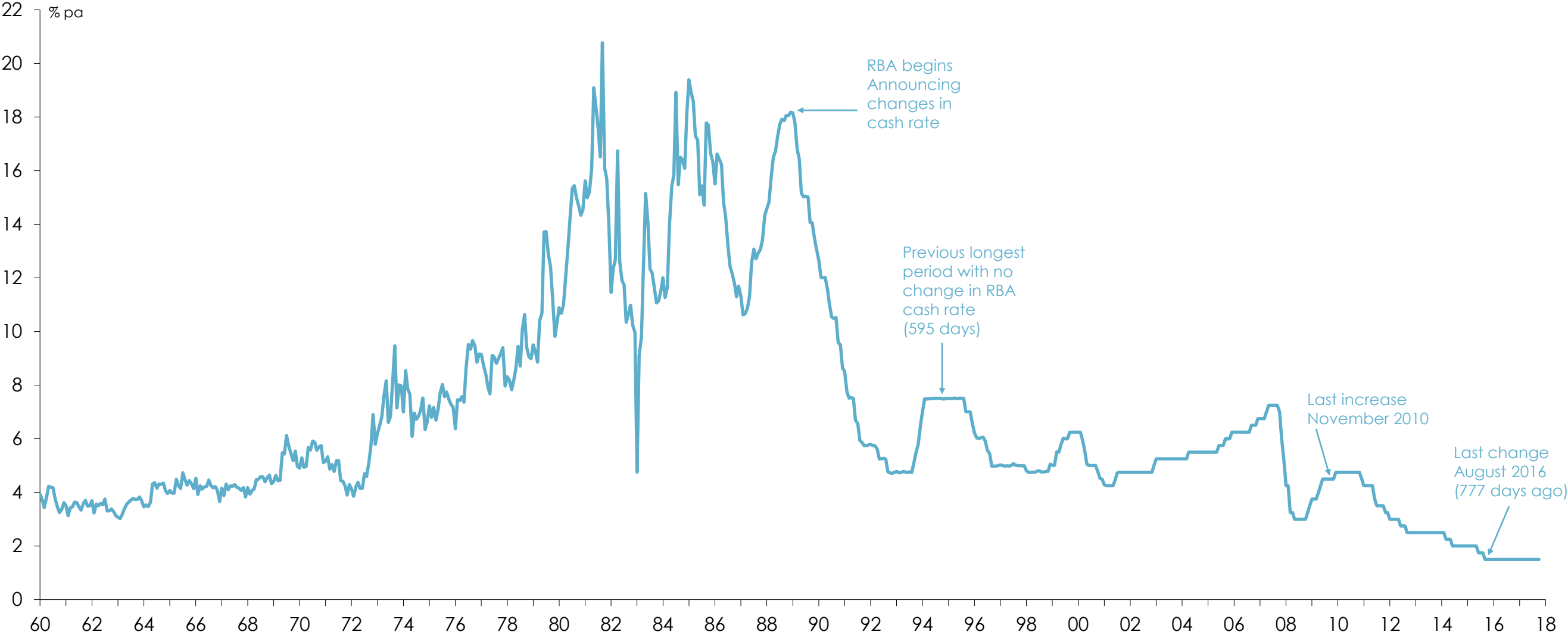
# THE AUSTRALIAN ECONOMY, PROPERTY PRICES, INTEREST RATES AND DEBT

PRESENTATION TO THE KESSLER FORUM 2018

CROWN MELBOURNE – 19<sup>TH</sup> SEPTEMBER 2018

# The Reserve Bank's official cash rate has remained at its historic low of 1.5% for more than two years

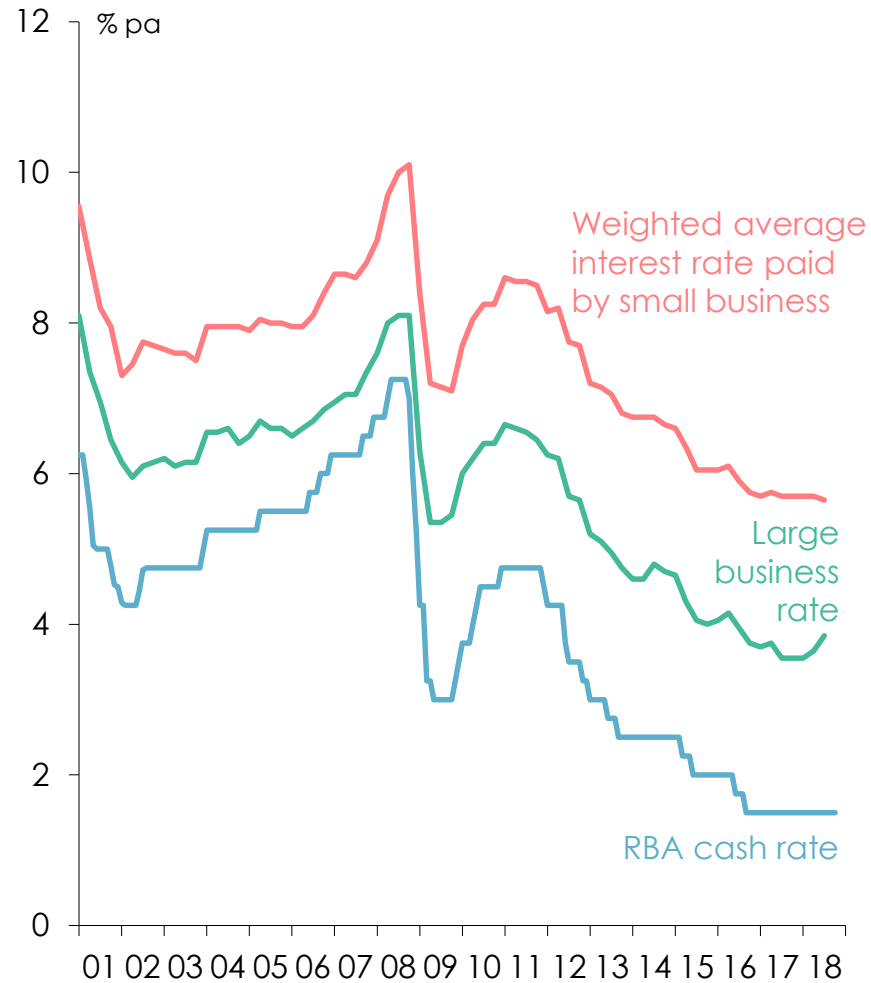
## The Reserve Bank's official cash rate



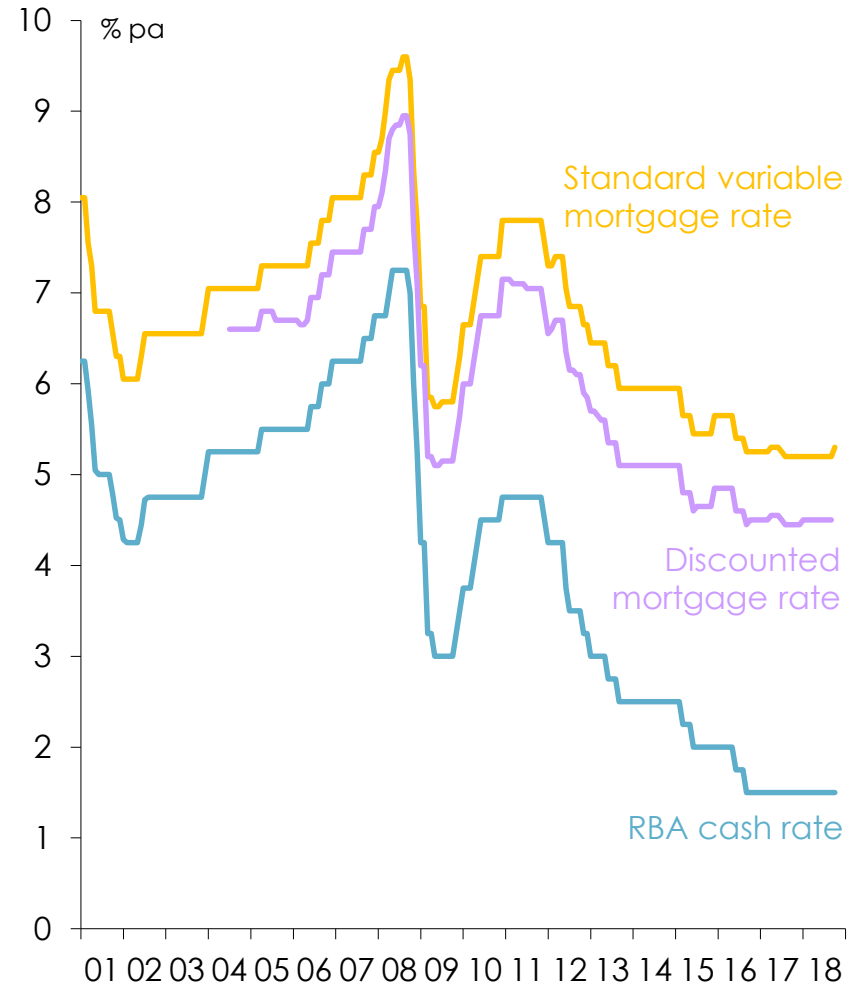
Source: Reserve Bank of Australia.

# Despite recent increases in some banks' mortgage rates, rates actually paid by borrowers remain very low – except for interest-only loans

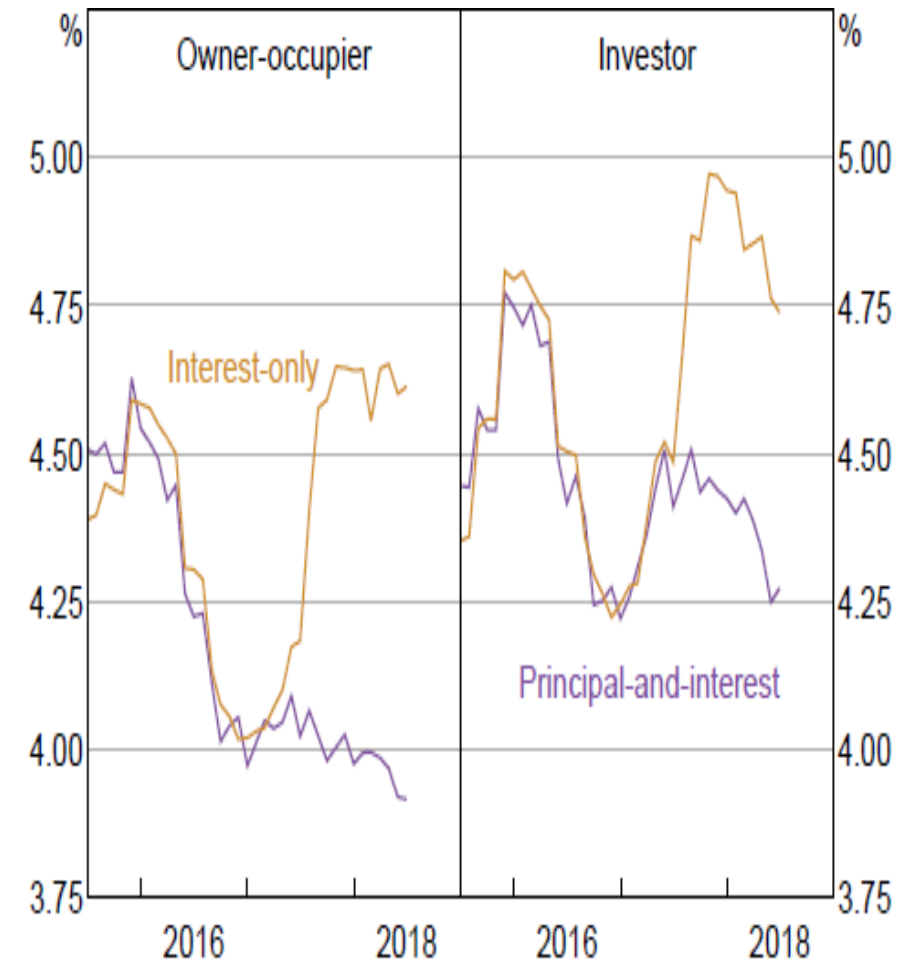
## Business loan interest rates



## Housing loan interest rates



## Variable interest rates on new housing loans

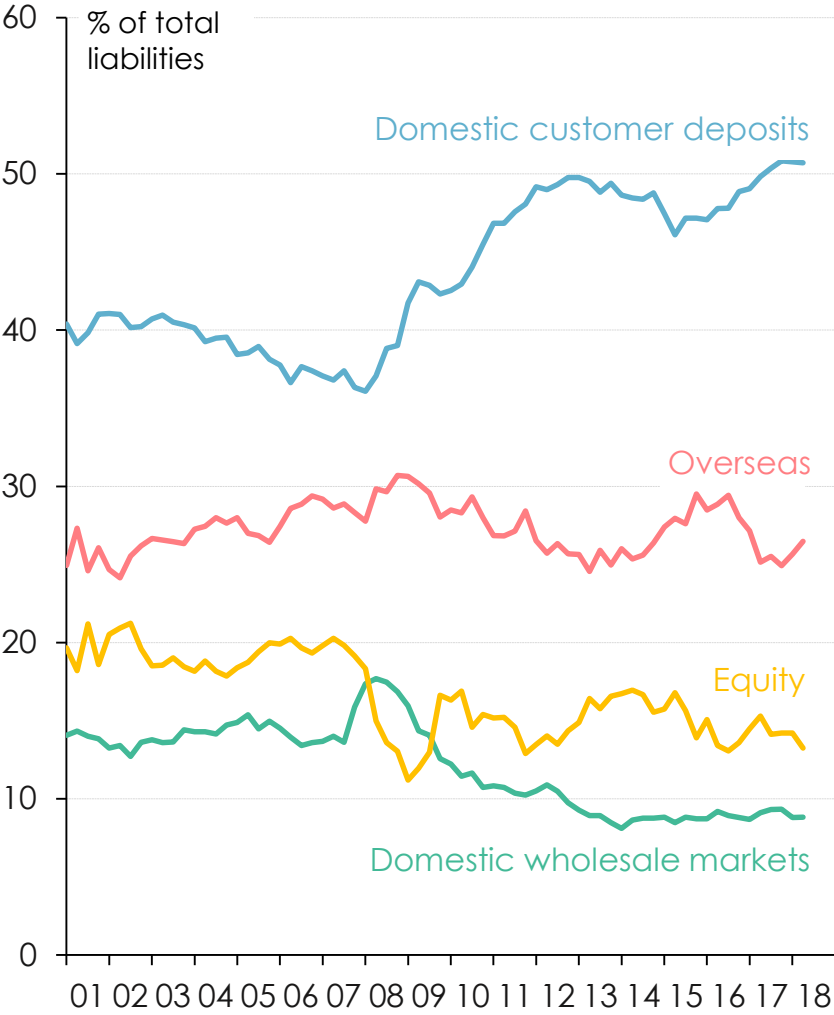


Note: the third chart is taken from the RBA's most recent *Statement on Monetary Policy*, published on 10<sup>th</sup> August 2018, and thus pre-dates the increases in variable mortgage rates announced by some banks in late August and early September 2018.

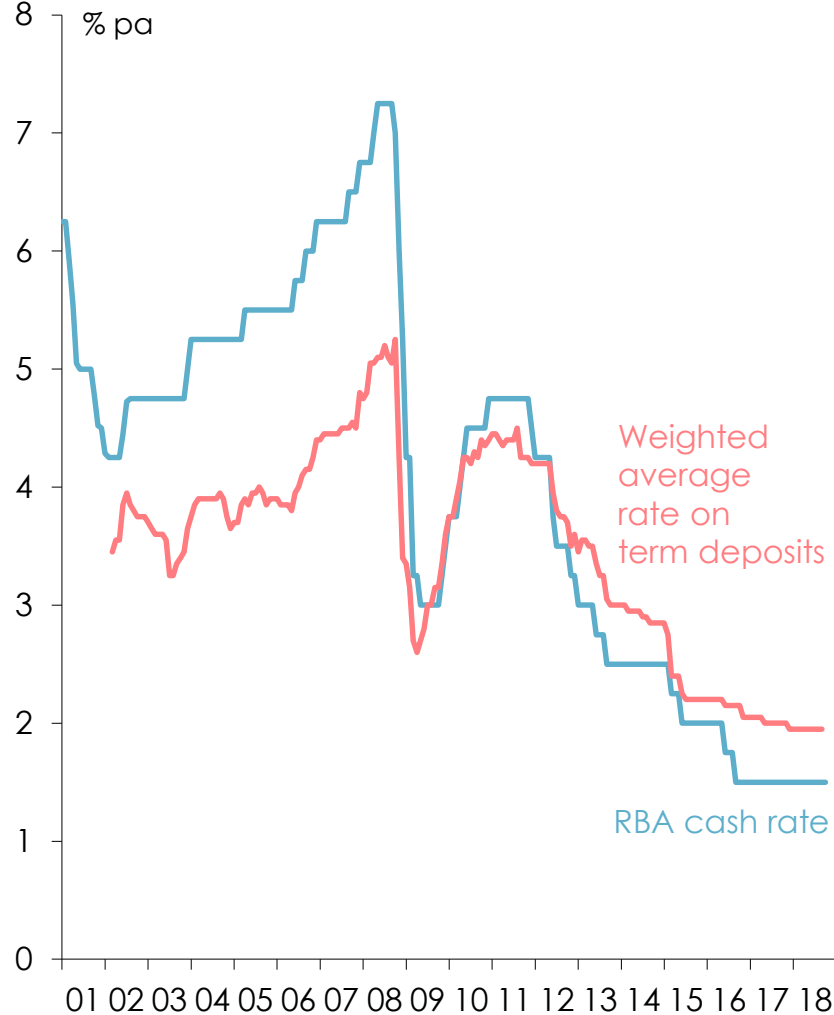
Source: Reserve Bank of Australia.

# Interest rates on customer deposits have been declining – but the cost of domestic ‘wholesale funding’ has risen since late last year

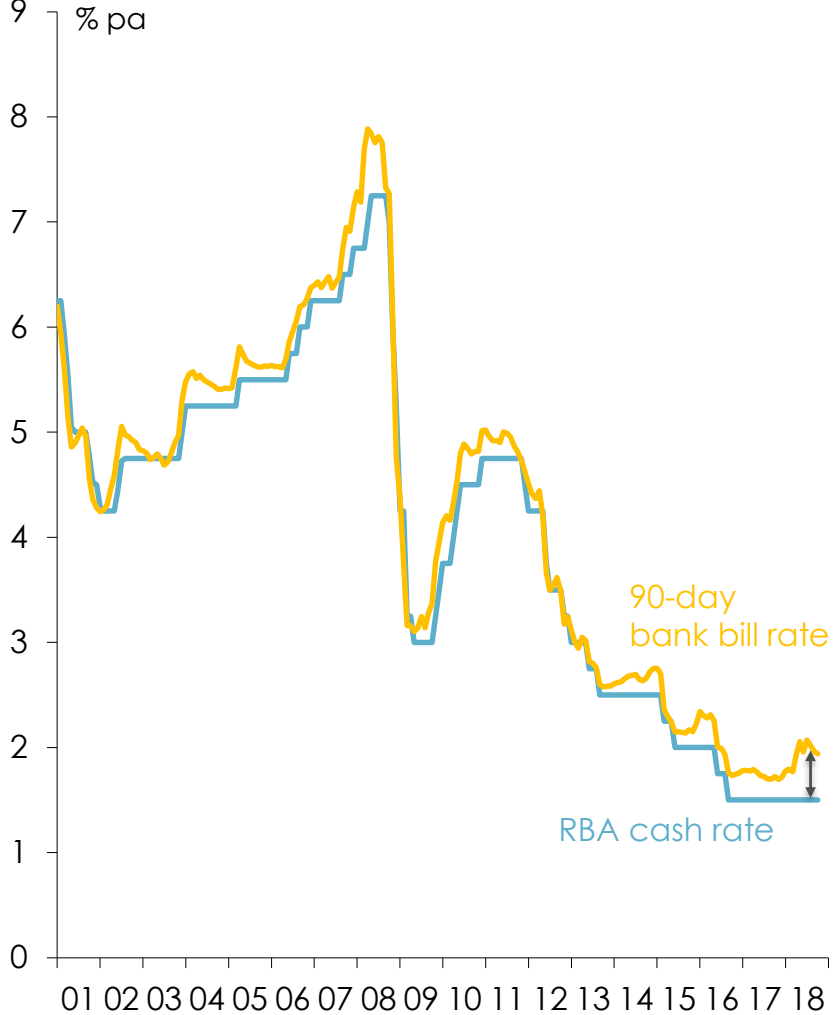
## Bank funding sources



## Deposit interest rates



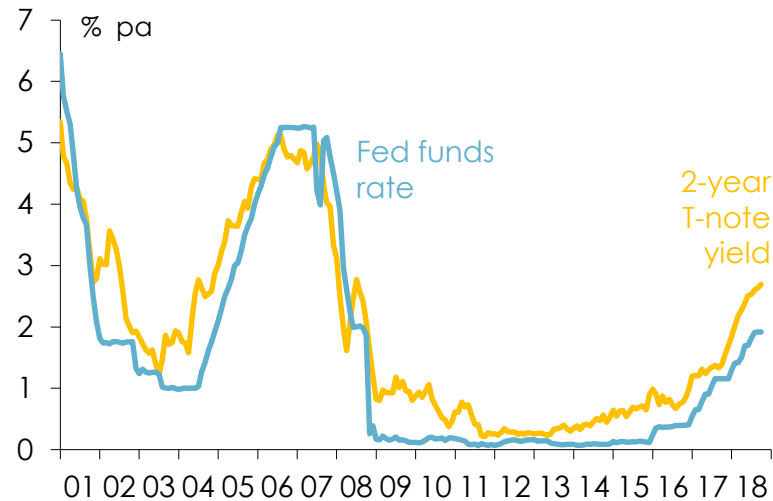
## Bank bill swap rate



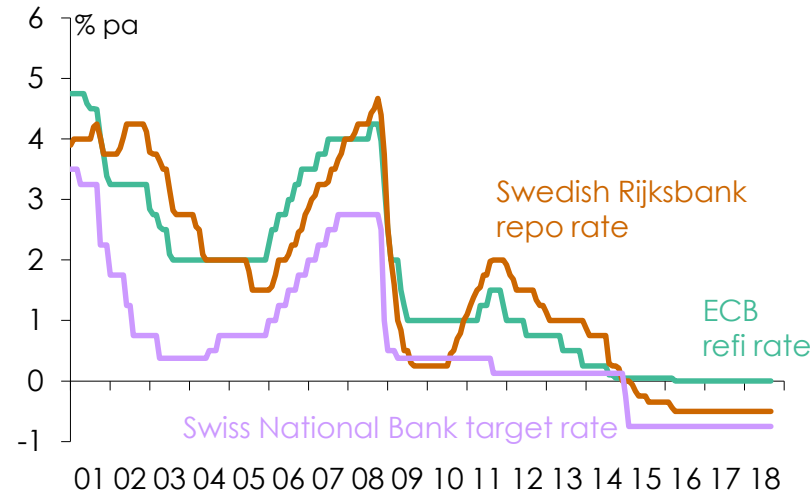
Sources: ABS; RBA; Thomson Reuters Datastream.

# Overseas funding costs are also rising as major 'advanced' economy central banks begin stepping away from ultra-easy monetary policies ...

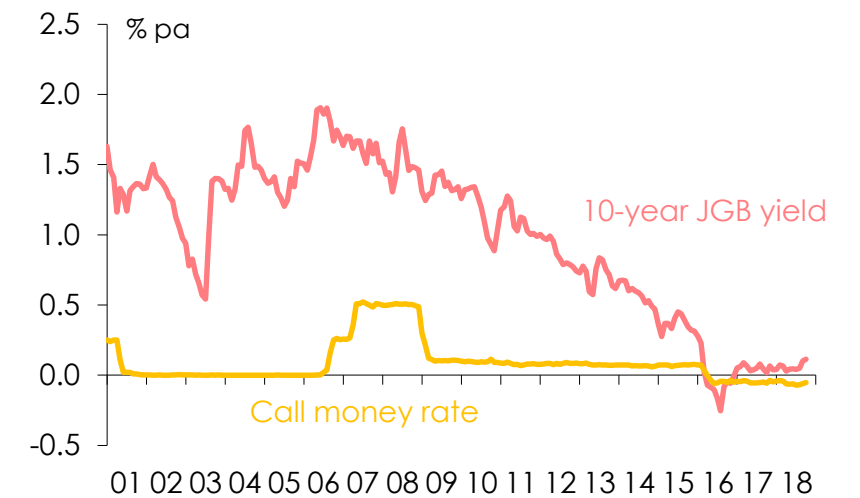
## United States



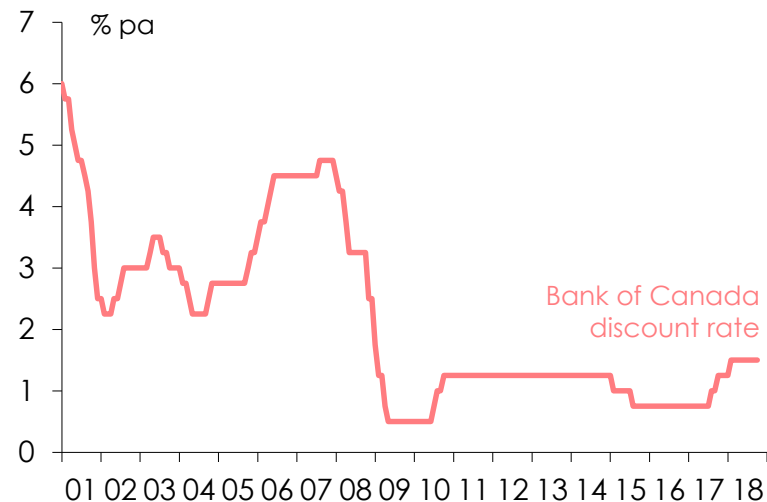
## Europe



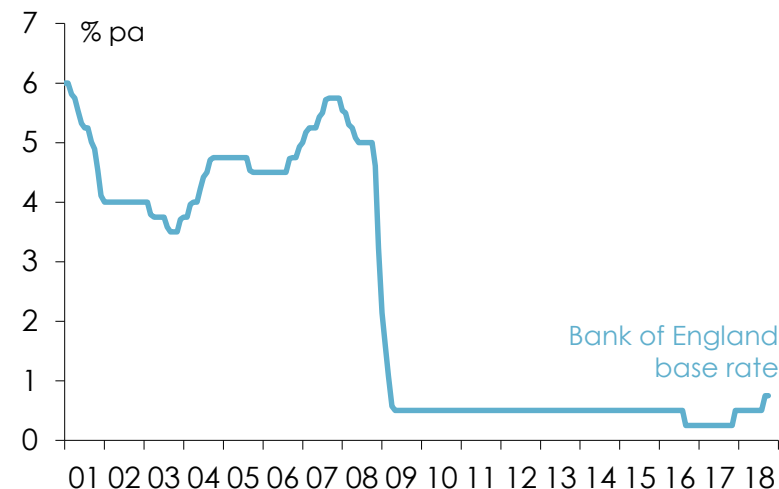
## Japan



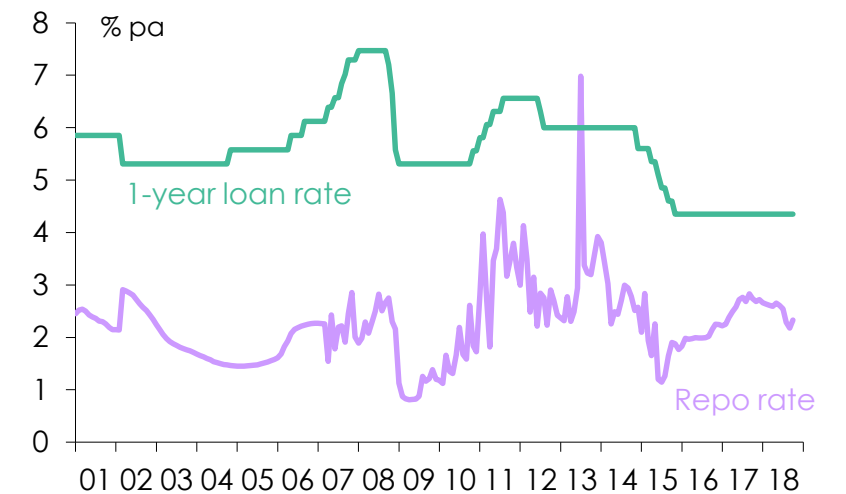
## Canada



## United Kingdom



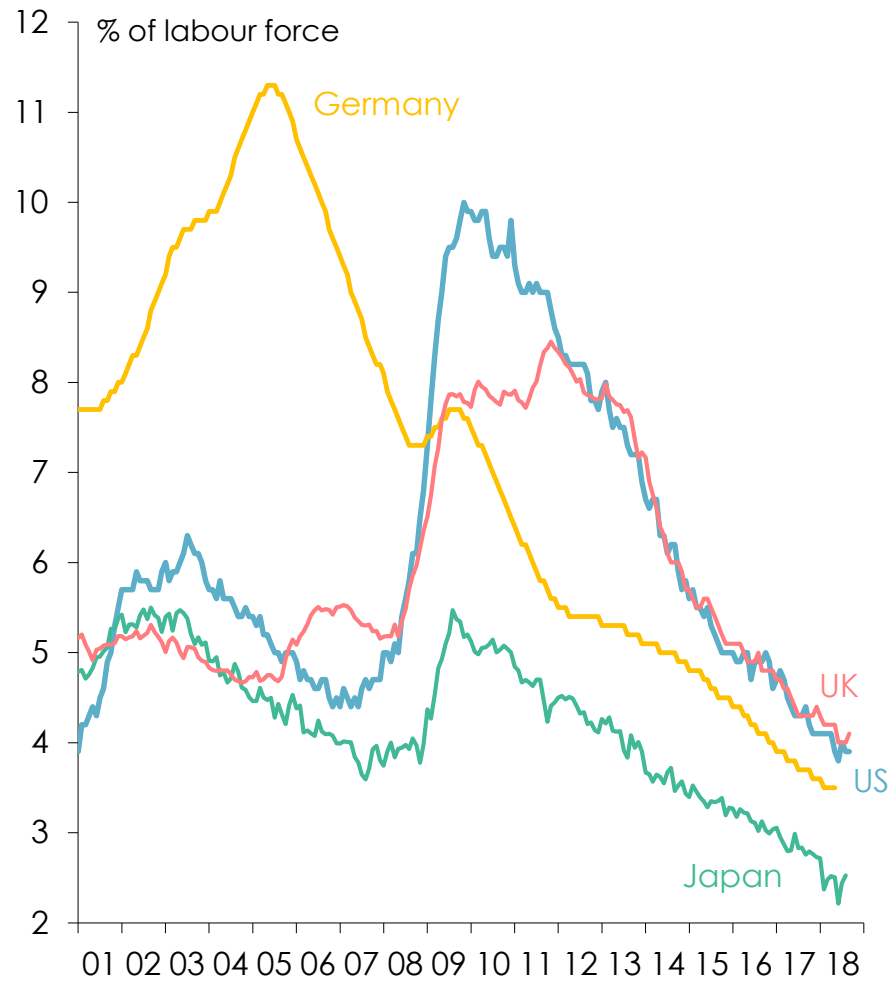
## China



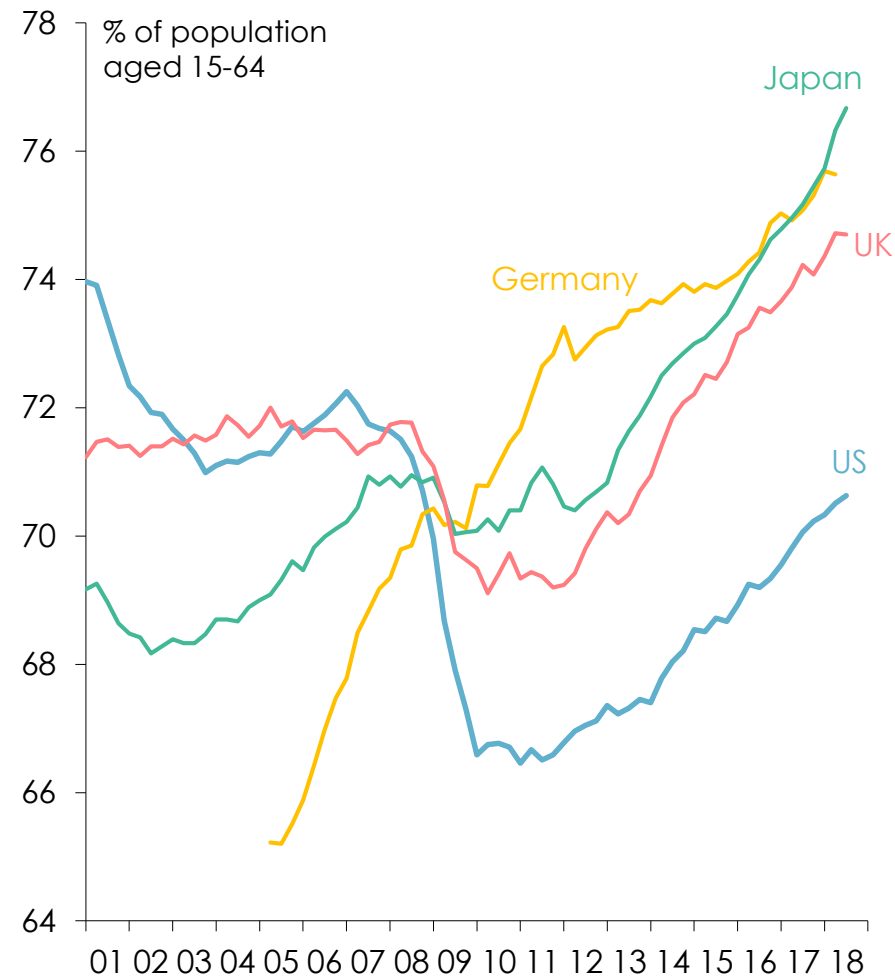
Sources: US Federal Reserve Board; Bank of Canada; European Central Bank; Swedish Riksbank; Swiss National Bank; Bank of England; Bank of Japan; People's Bank of China; Thomson Reuters Datastream.

# ... which they're doing because unemployment is now low by historical standards – and inflation is getting back towards central bank targets

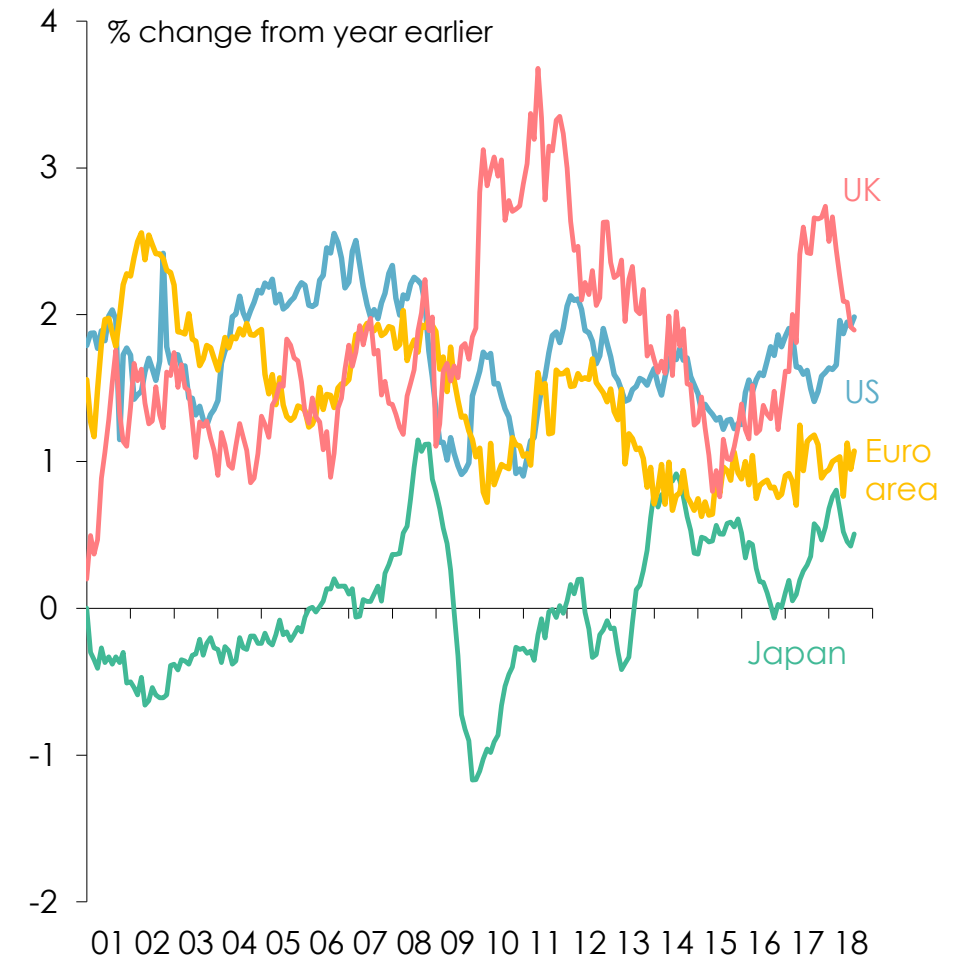
## Unemployment – 4 largest 'advanced' economies



## 'Employment rates' – 4 largest 'advanced' economies



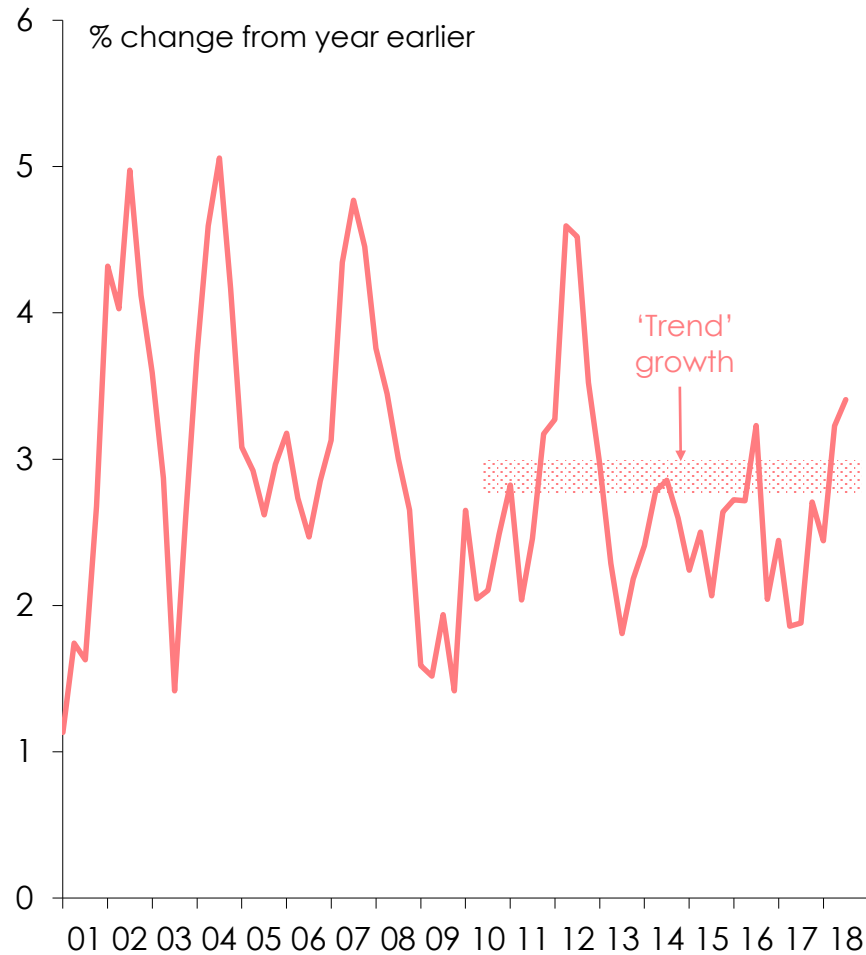
## 'Core' inflation rates – 4 largest economies



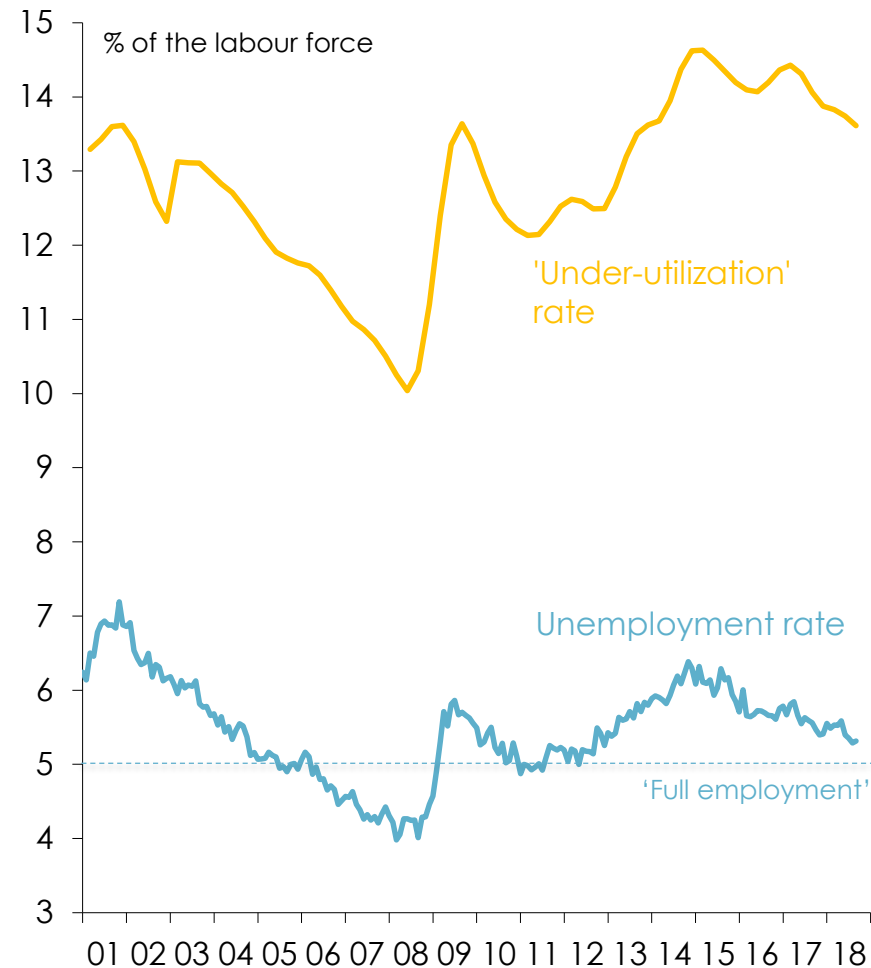
Sources: national statistical agencies; OECD. 'Core' inflation measures are those targeted by central banks – in the US, the implicit price deflator of personal consumption expenditure excluding food and energy; in Japan, the 'trimmed mean' consumer price index; in the euro area and the UK, the 'harmonized' consumer price index excluding food and energy.

# Australian economic growth is now above 'trend', but unemployment and 'under-employment' are still too high, and inflation is still below target

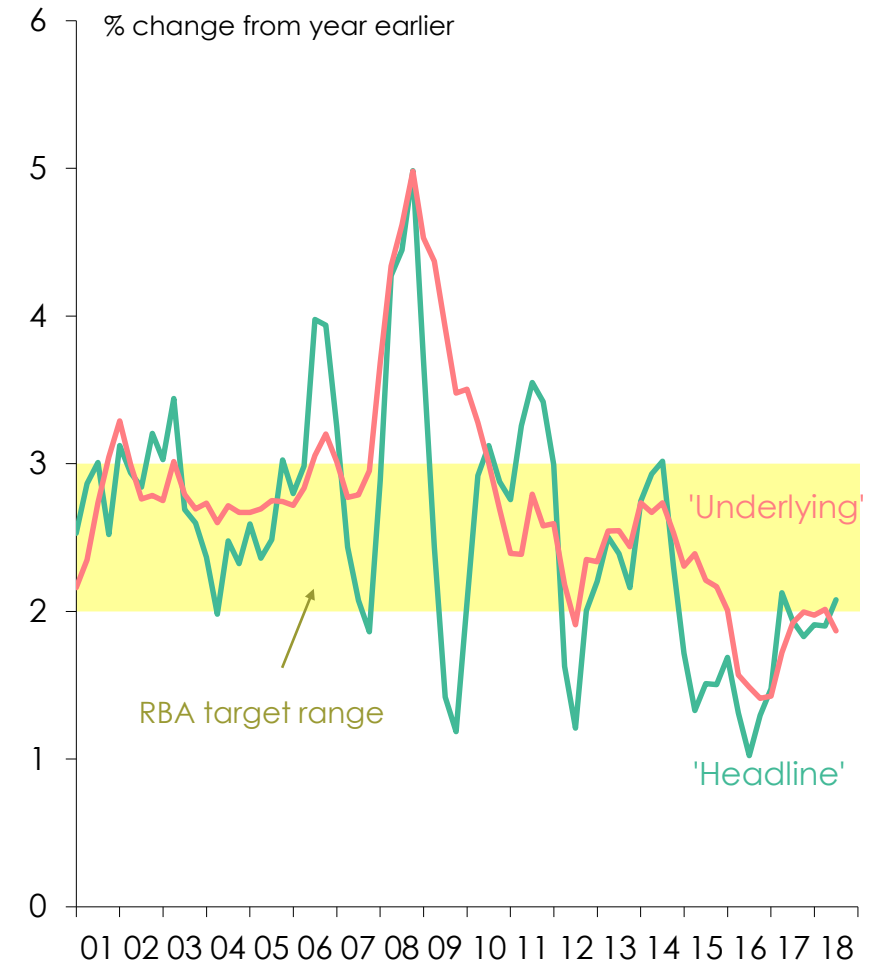
## Real GDP growth



## Unemployment and under-employment



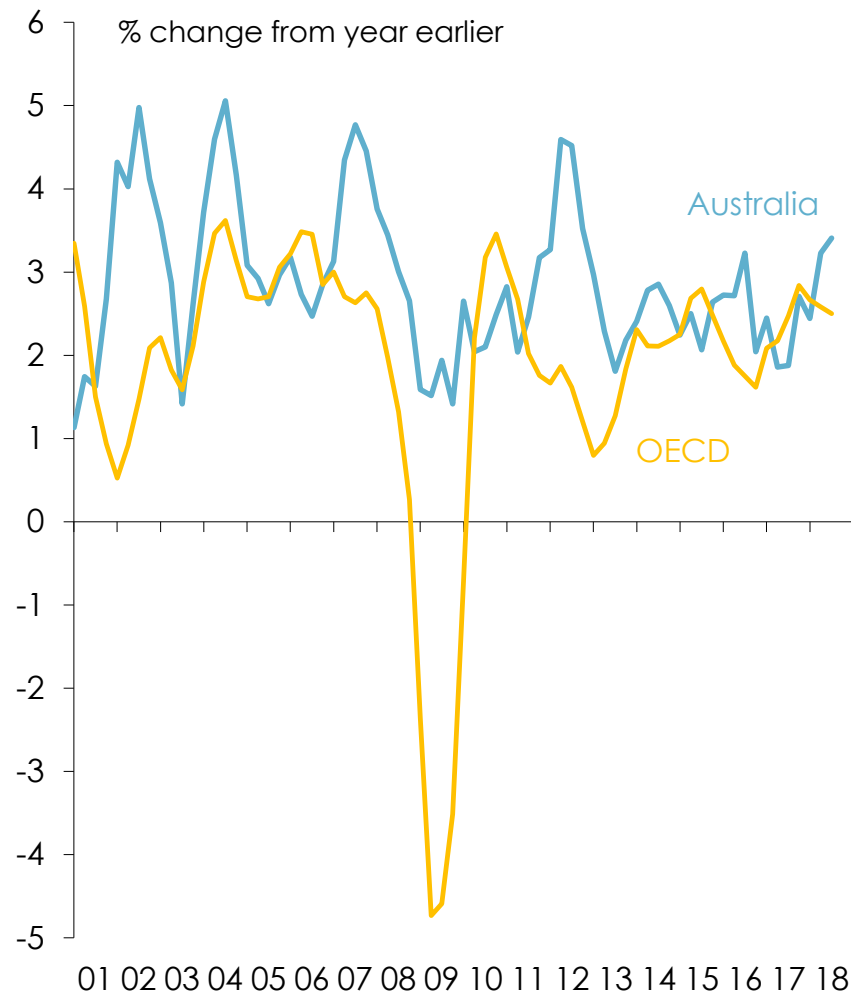
## Consumer prices



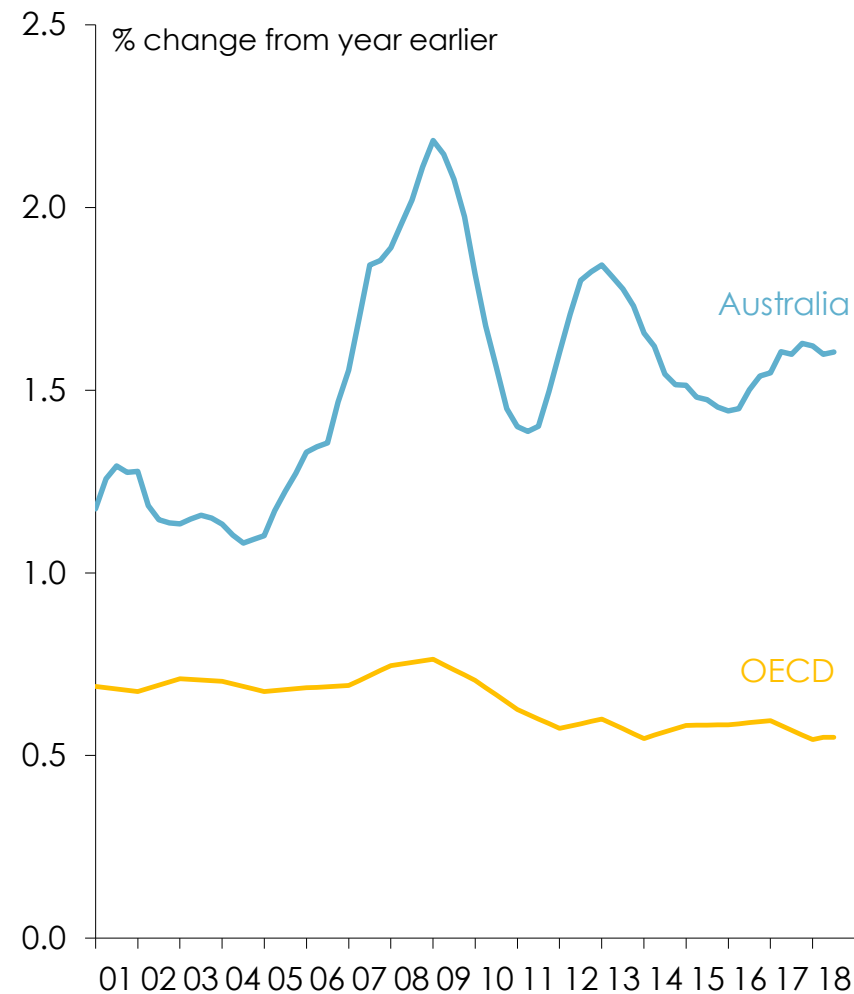
Note: The labour force 'under-utilization' rate includes people employed part-time who are willing and able to work longer hours (and weights them equally with people who are 'unemployed' in the conventional sense). 'Underlying' inflation abstracts from the impact of volatile items (typically items such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

# Australia's above-average economic growth owes a lot to above-average population growth – excluding which, our growth rate is below-average

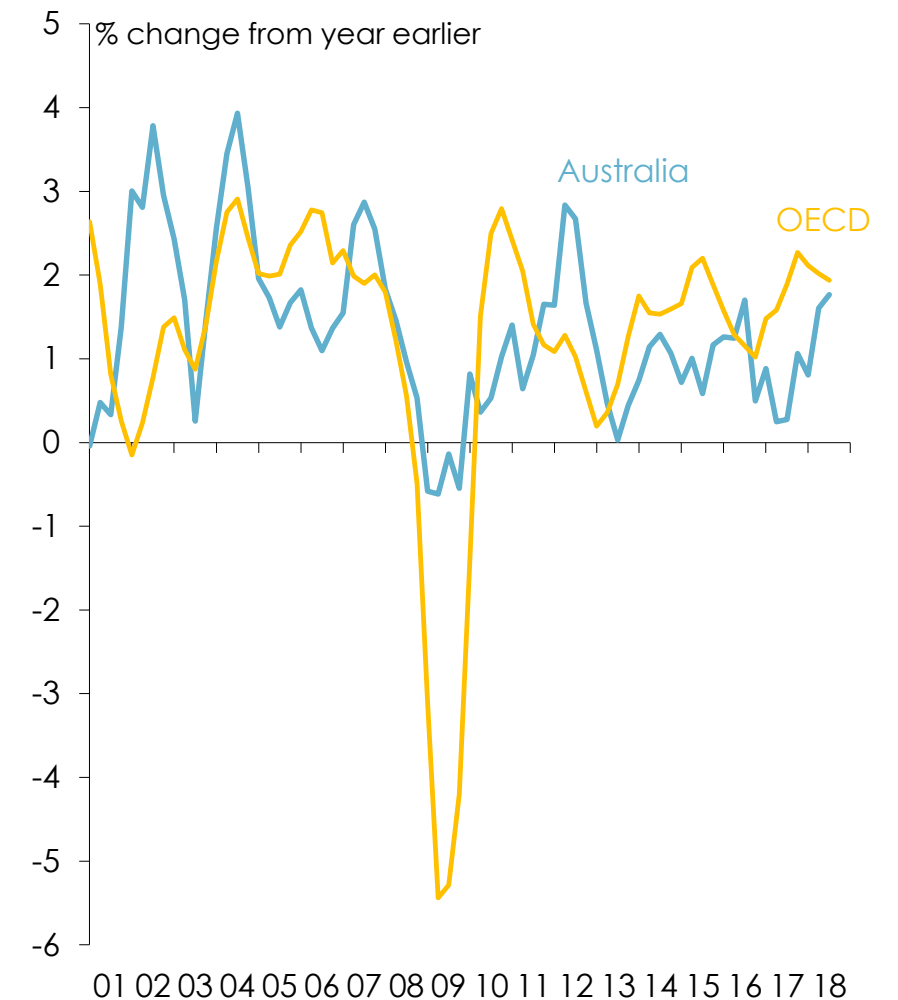
## Real GDP growth



## Population growth



## Real per capita GDP growth

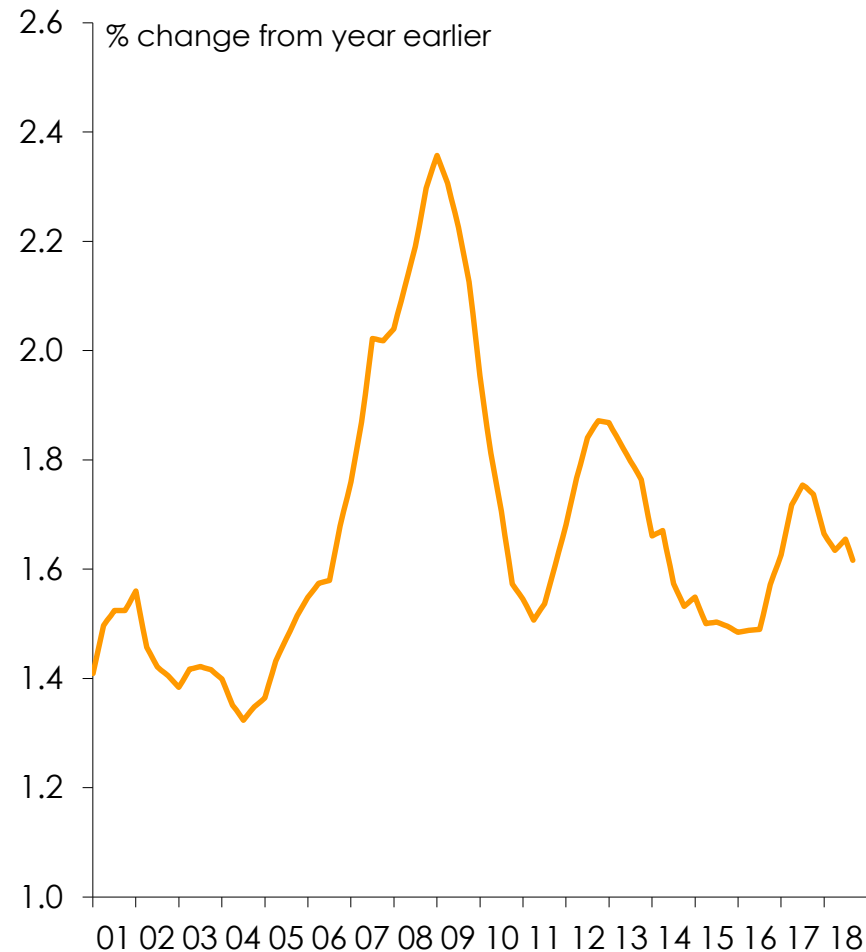


Note: OECD (Organization for Economic Co-operation and Development) comprises 34 (mostly) 'advanced' economies in Europe and North America plus Japan, Korea, Australia, New Zealand, Mexico, Chile, Turkey and Israel.  
Sources: Australian Bureau of Statistics; OECD.

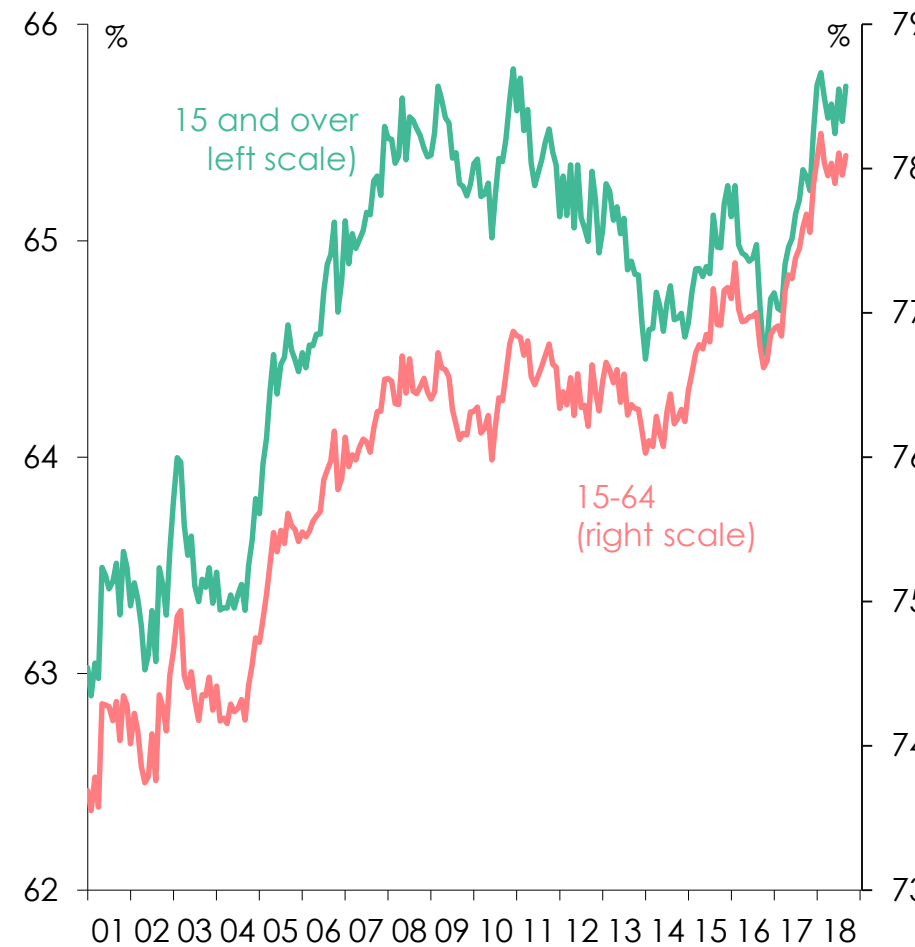


# Population growth, combined with rising work force participation, explains why strong employment growth hasn't lowered unemployment very much

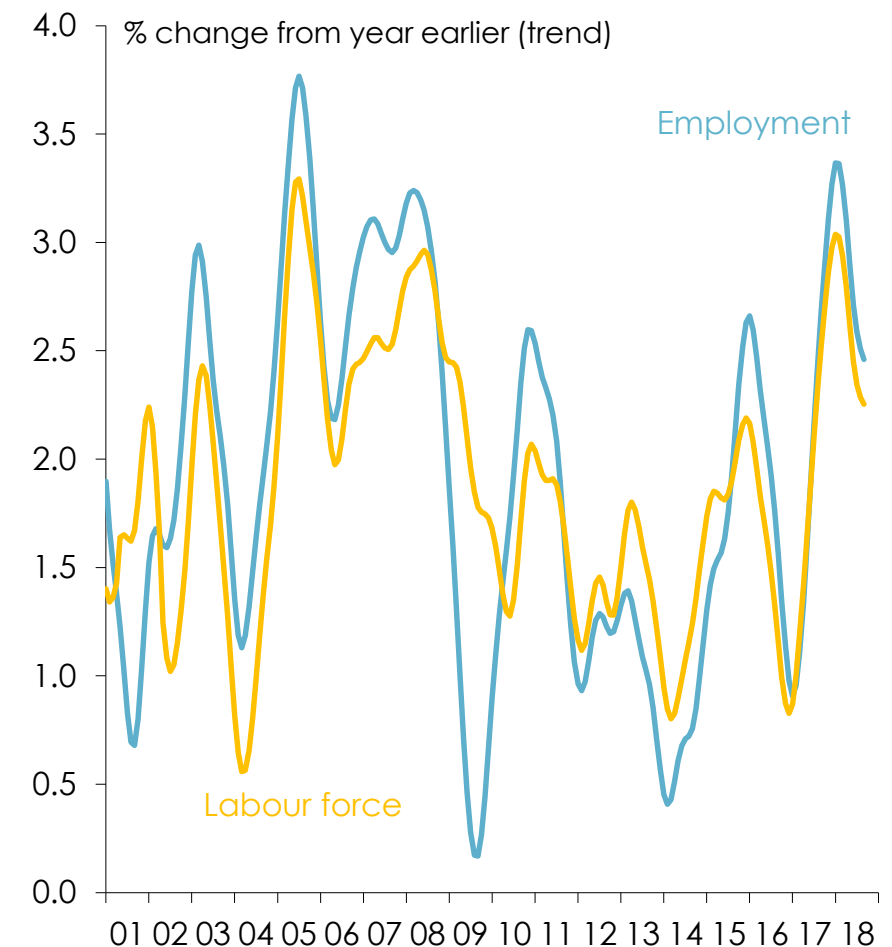
## Civilian working-age (15+) population growth



## Labour force participation rates



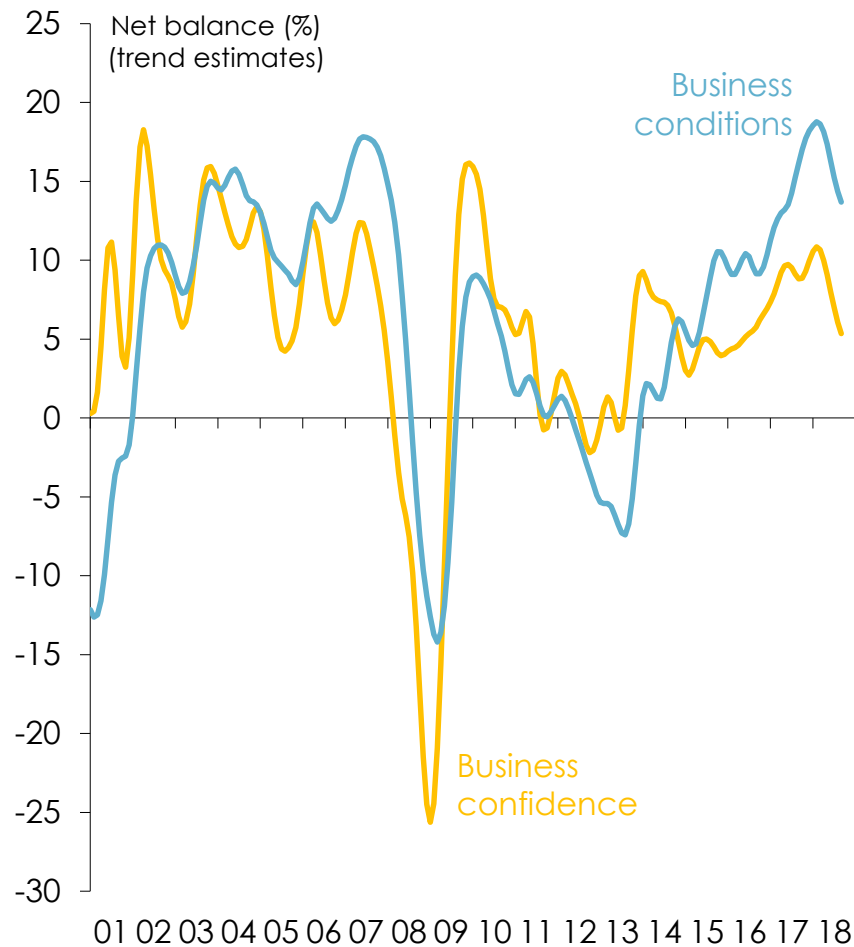
## Employment and labour force growth



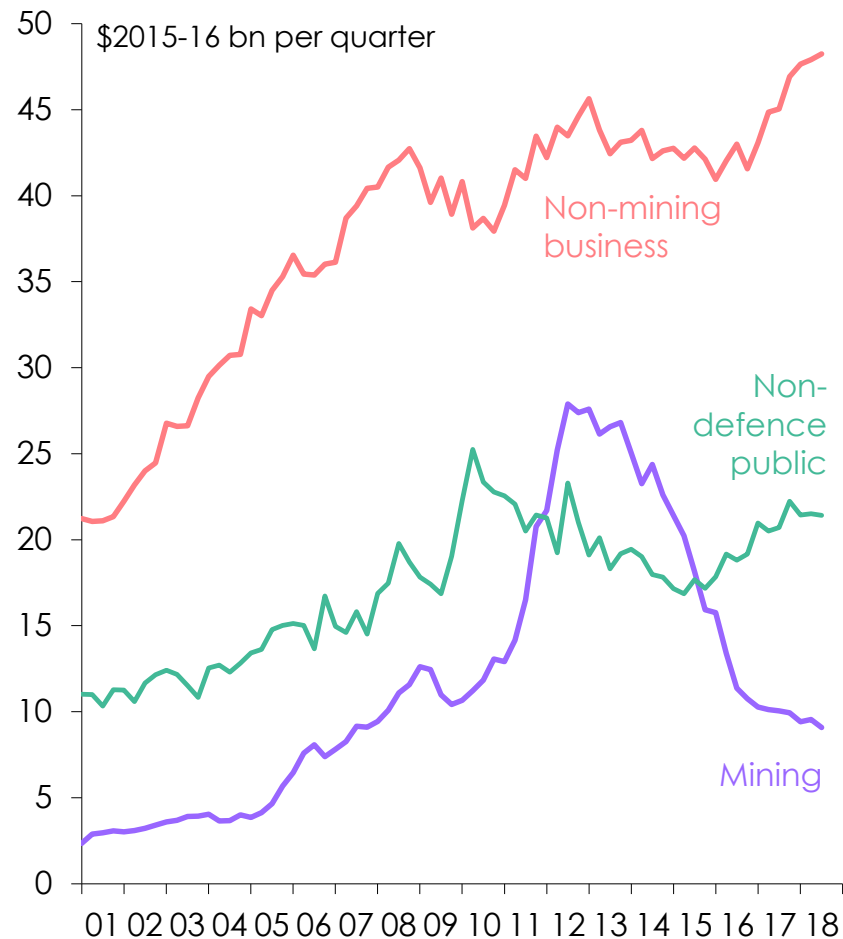
Note: The labour force participation rate is the proportion of the working-age population (15+) or population aged 15-64 who are either in employment, or actively seeking employment (ie, unemployed). Source: ABS.

# Business conditions remain above average, non-mining business investment is picking up, and resources exports are growing strongly

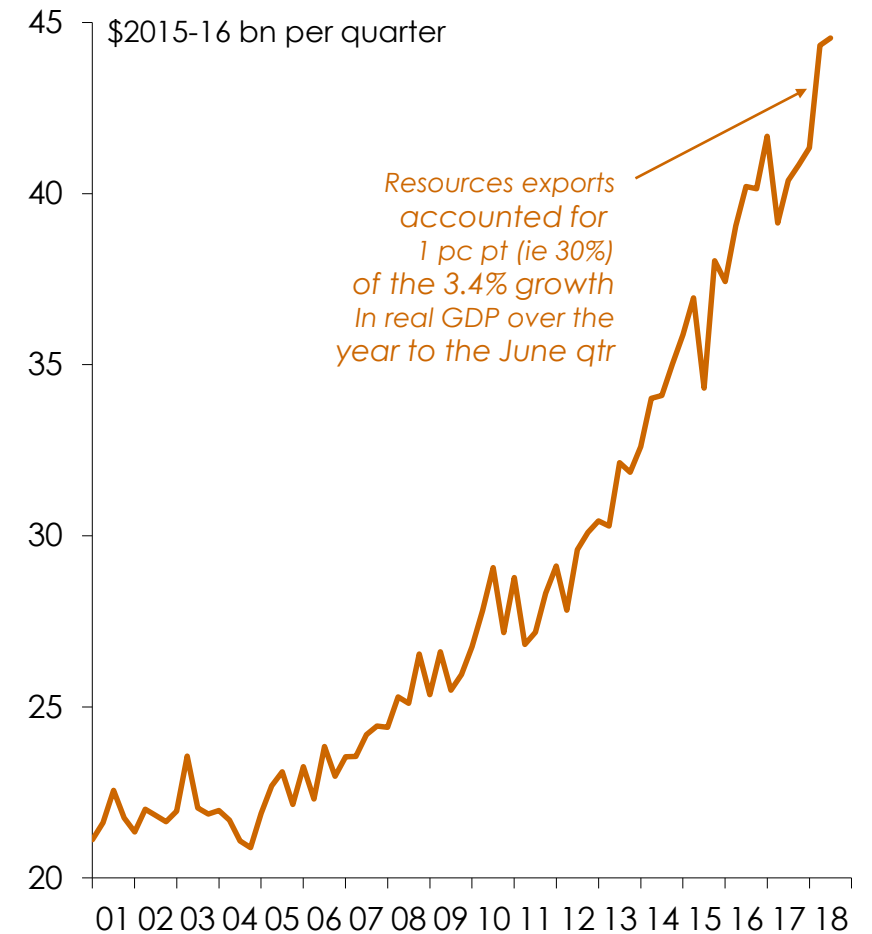
## Business conditions and confidence



## Non-residential investment – mining vs other sectors



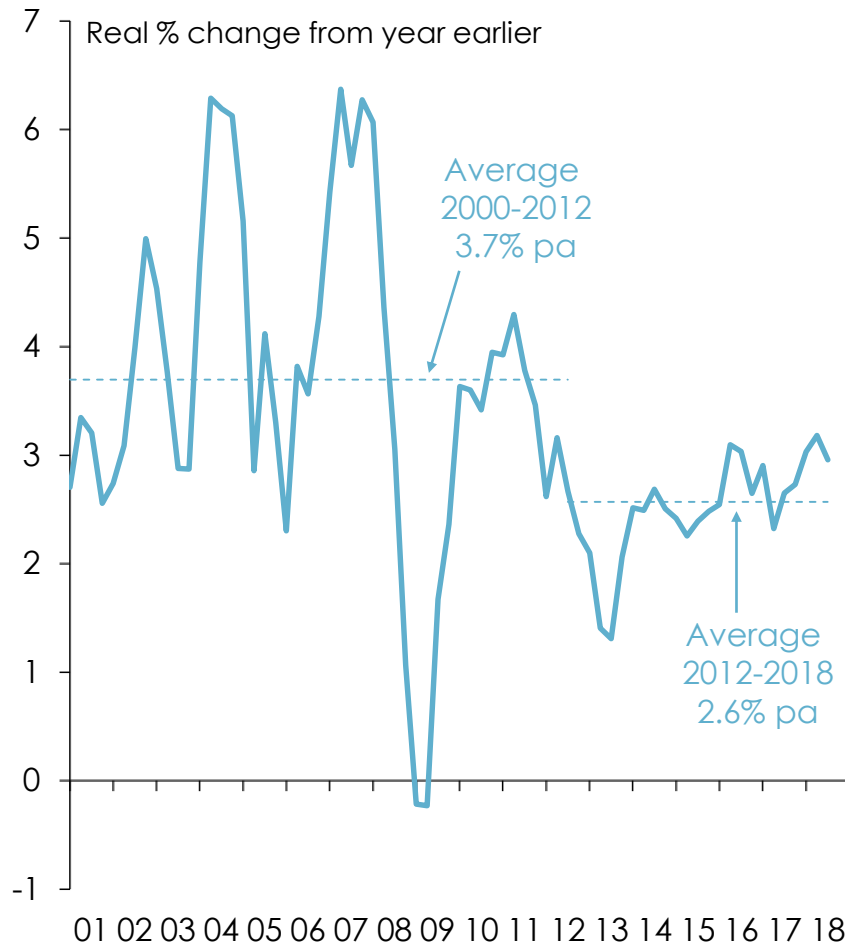
## Volume of resources exports



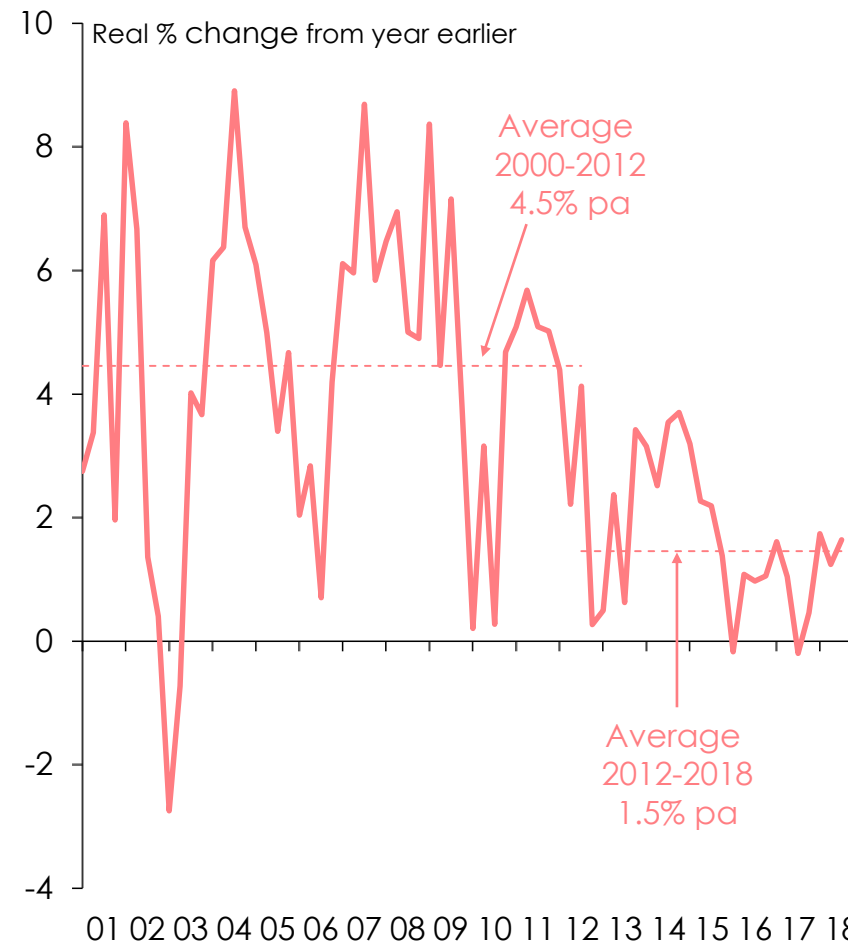
Sources: National Australia Bank; ABS.

# Household spending has grown faster over the past year than the post-mining boom average, but that can't be sustained unless income picks up

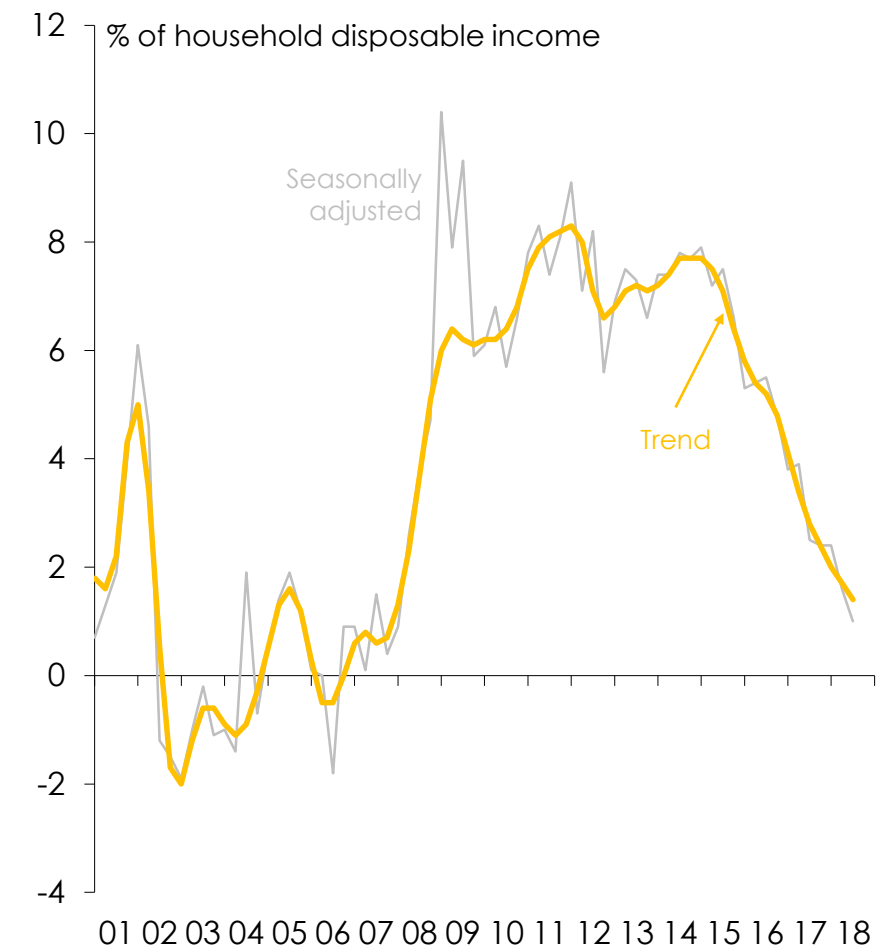
## Household consumption expenditure



## Household disposable income



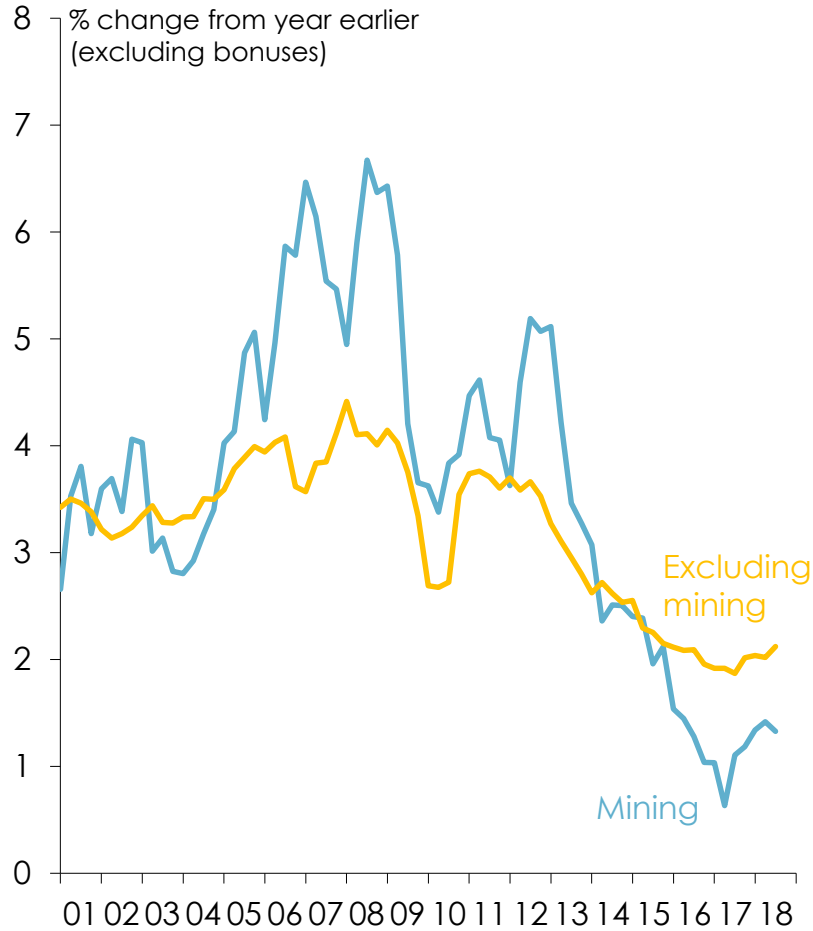
## Household saving



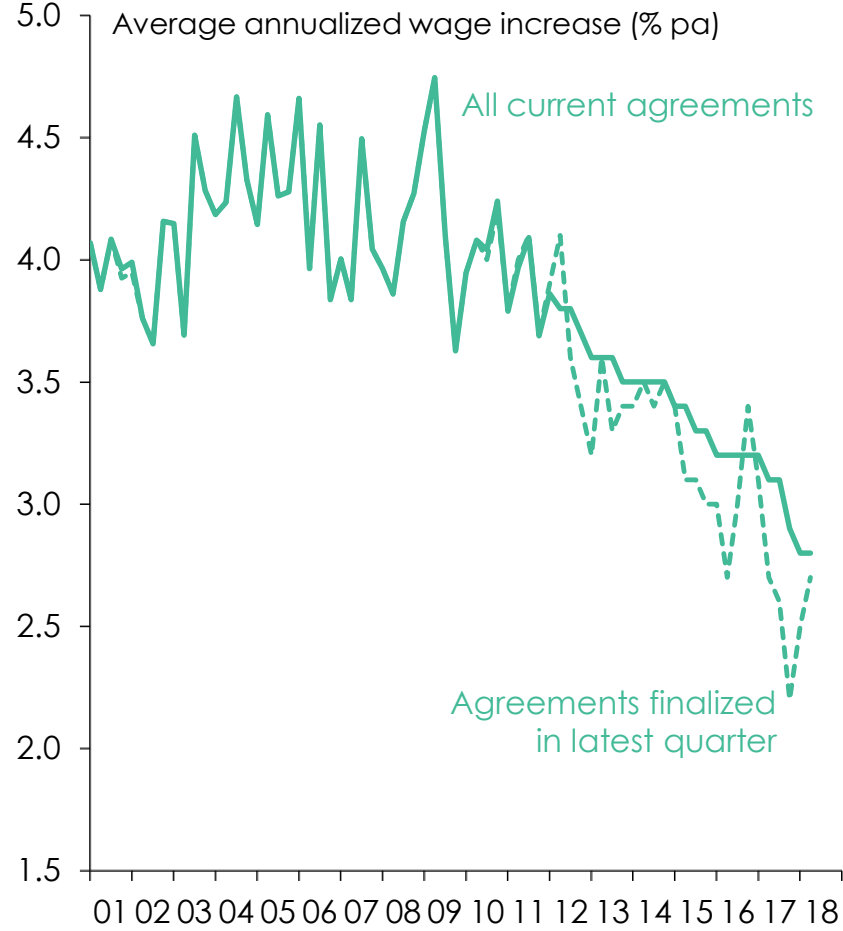
Source: ABS.

# As in other countries wages growth remains soft, although it may be bottoming – but skill shortages don't seem to be making much difference

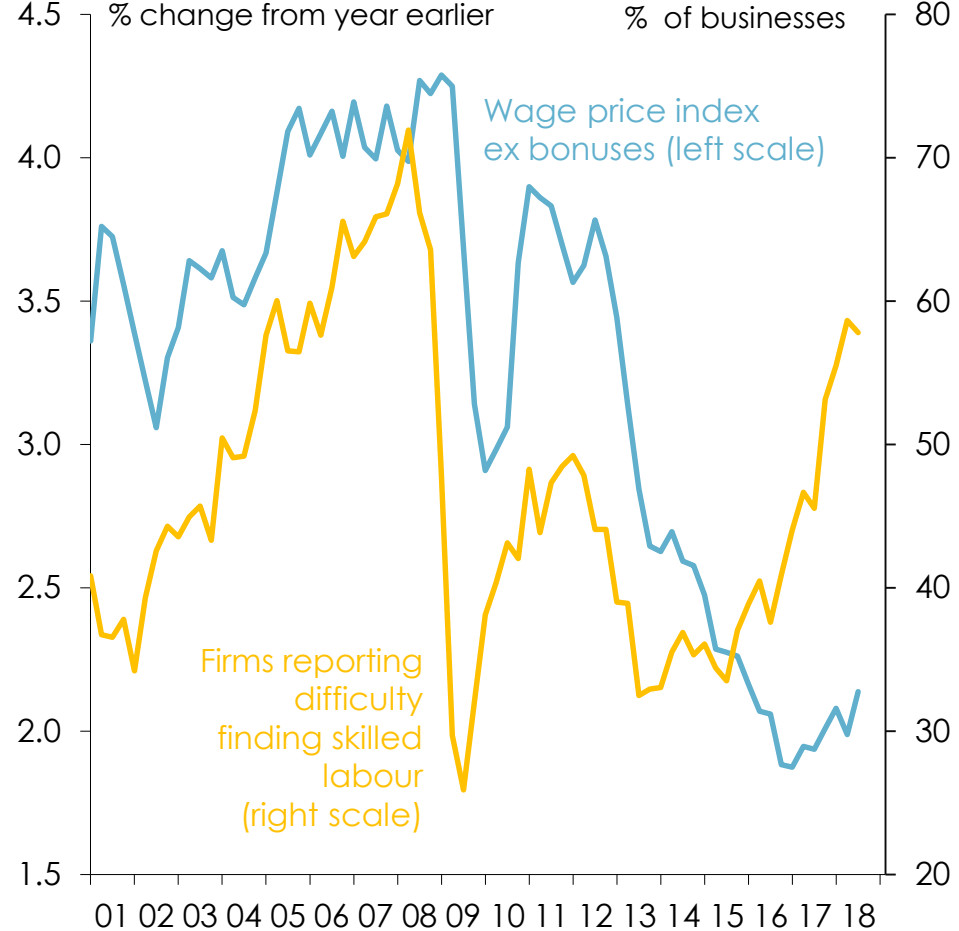
## Wages growth



## Enterprise agreements



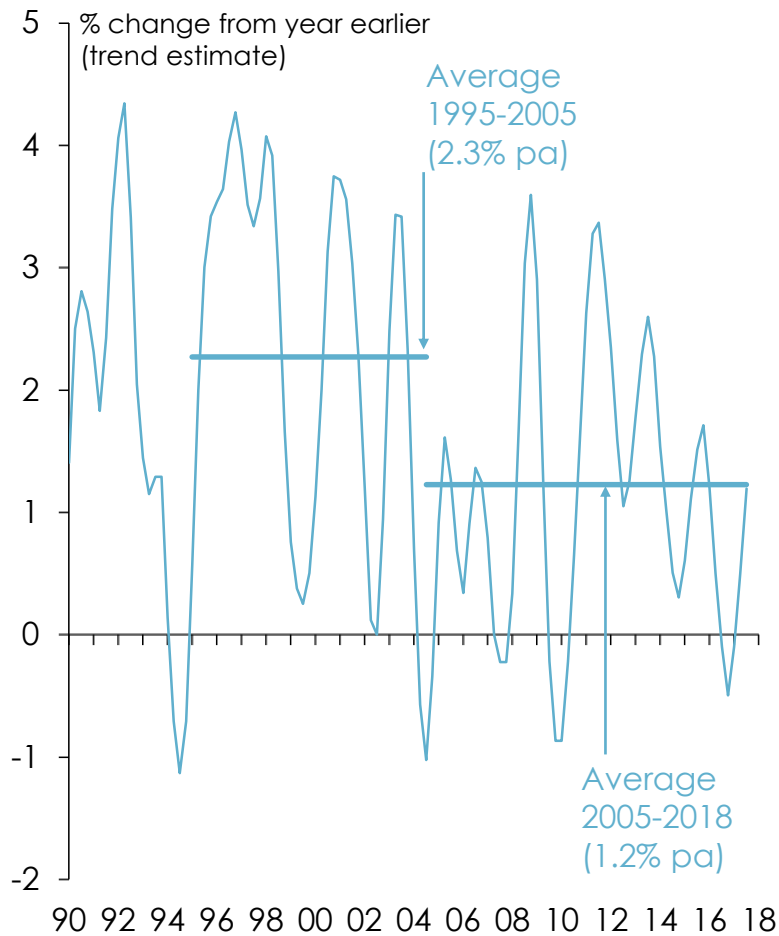
## Labour shortages and wage increases



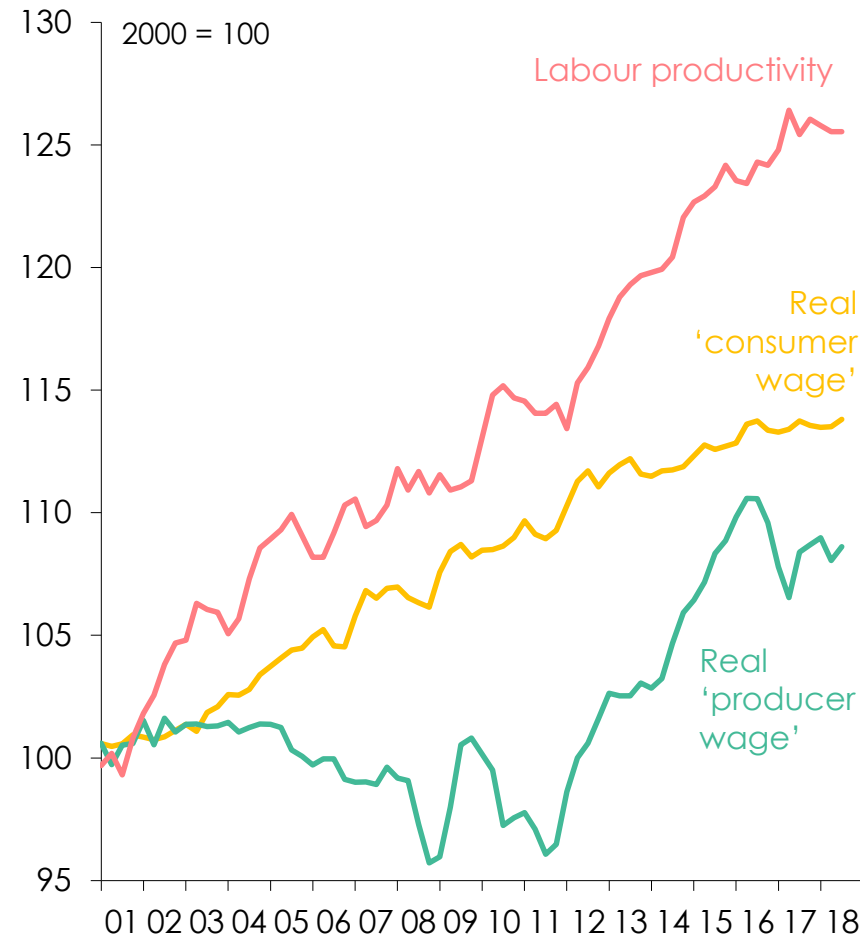
Sources: ABS ; Australian Government Department of Jobs and Small Business ; National Australia Bank

# Low wages growth partly reflects slower productivity growth – but that isn't the only reason because wages have grown even less than productivity

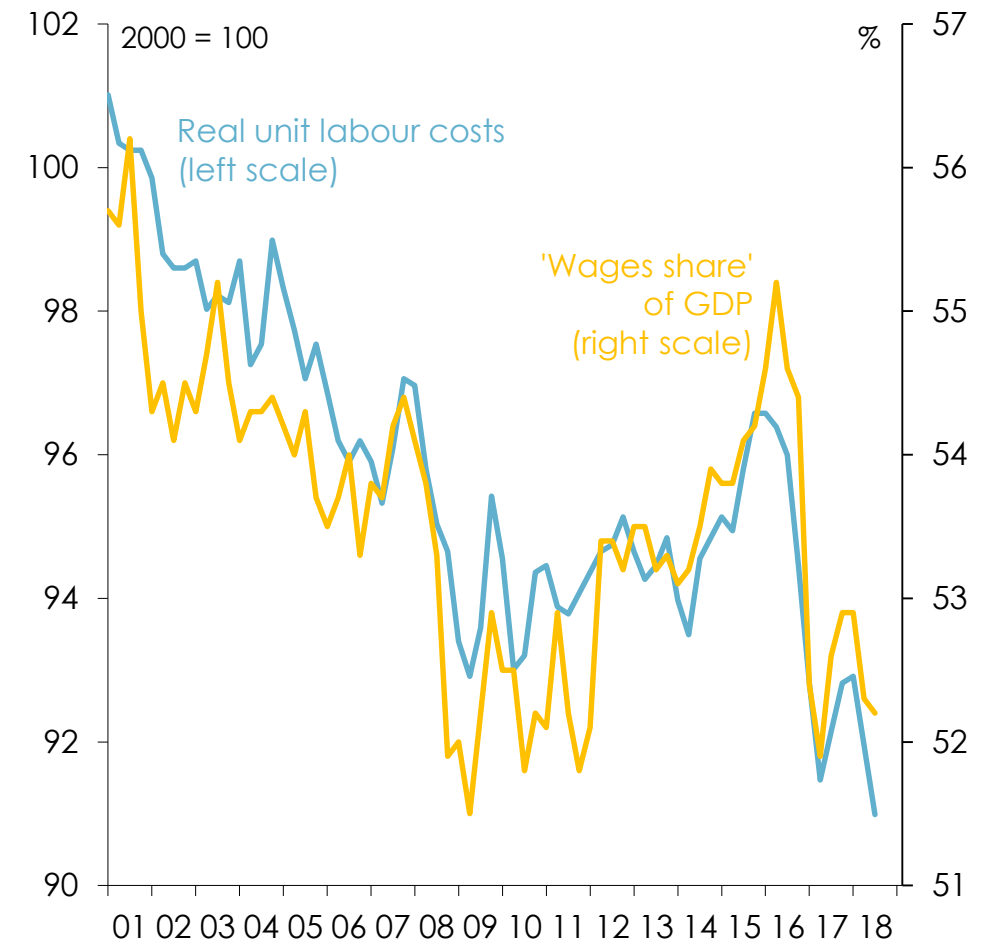
## Labour productivity growth



## Productivity and real wages growth



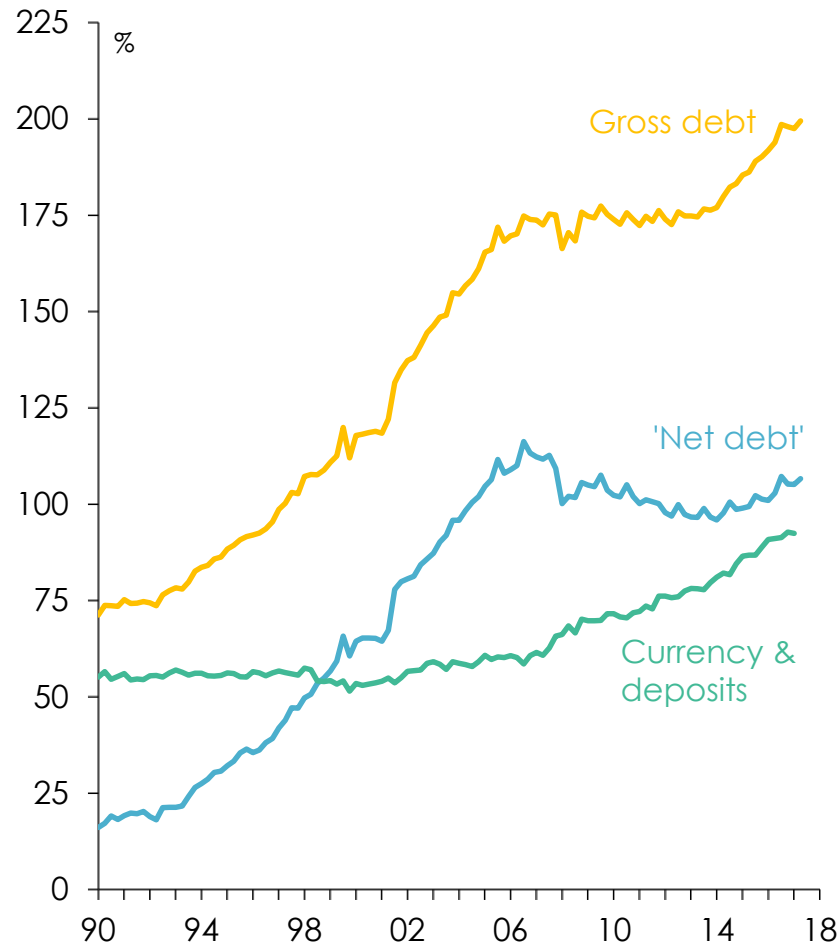
## Real unit labour costs and the 'wages share' of GDP



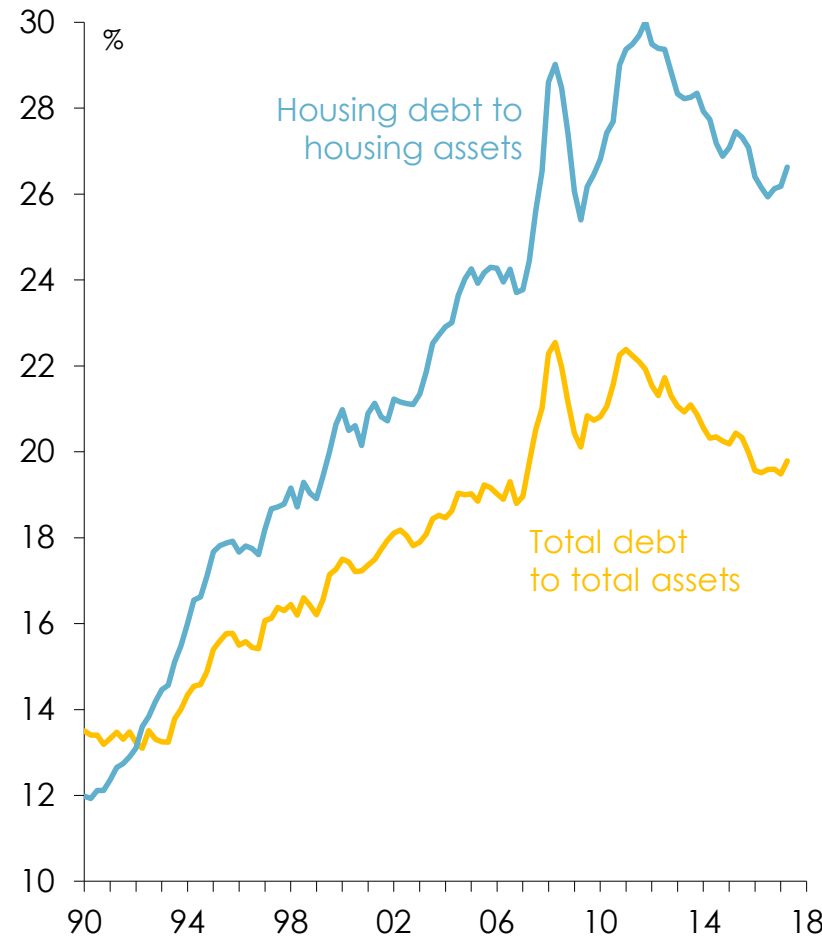
Note: The real 'consumer wage' is the wage price index deflated by the CPI (ie, real wages from employees' standpoint). The real 'producer wage' is the wage price index deflated by the implicit price deflator of non-farm GDP (ie, real wages from employers' standpoint). 'Real unit labour costs' is real wages (plus on-costs) per unit of output, or (equivalently) wages (and on-costs) per hour divided by output per hour (labour productivity). Source: ABS.

# Household gross debt is at a record high percentage of household income – but net debt isn't, nor is gearing, or debt servicing

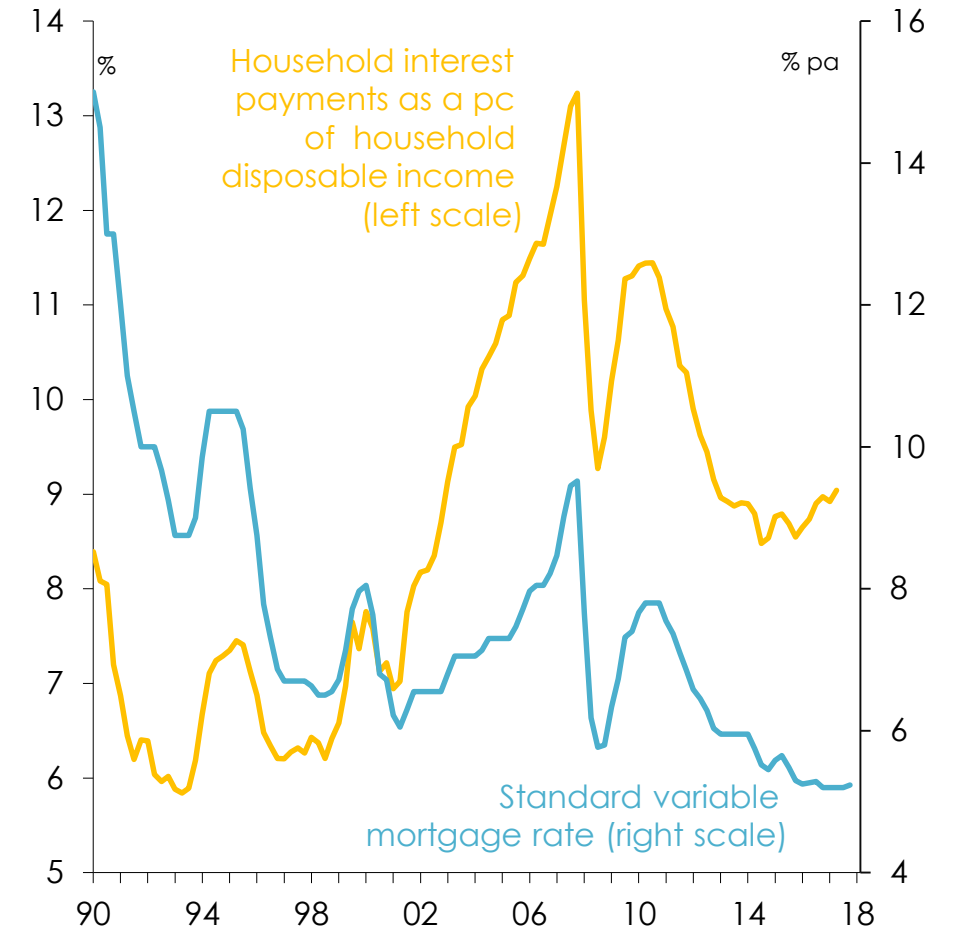
## Household gross debt, liquid assets and net debt



## Household debt-to-assets ratio



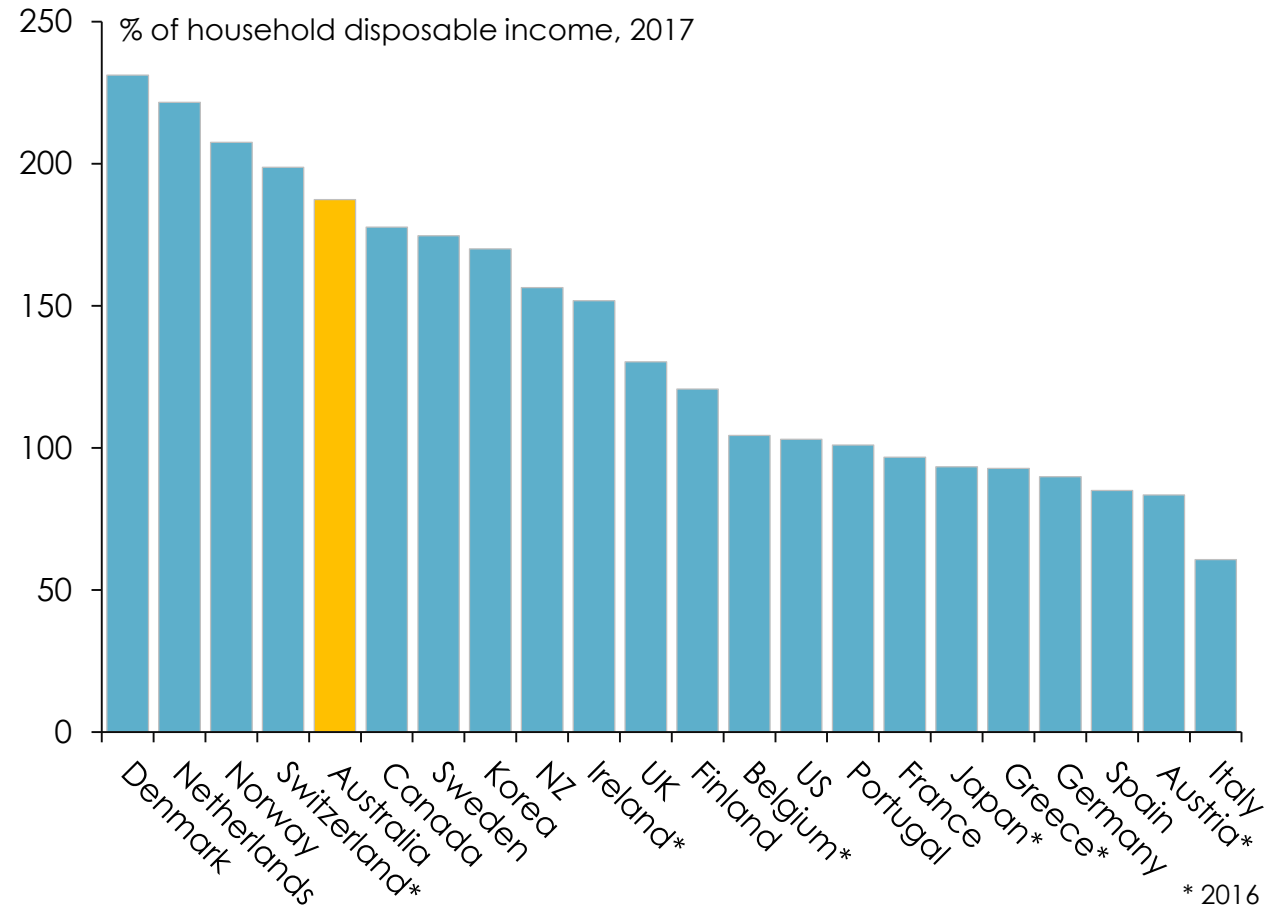
## Household interest-to-income ratio



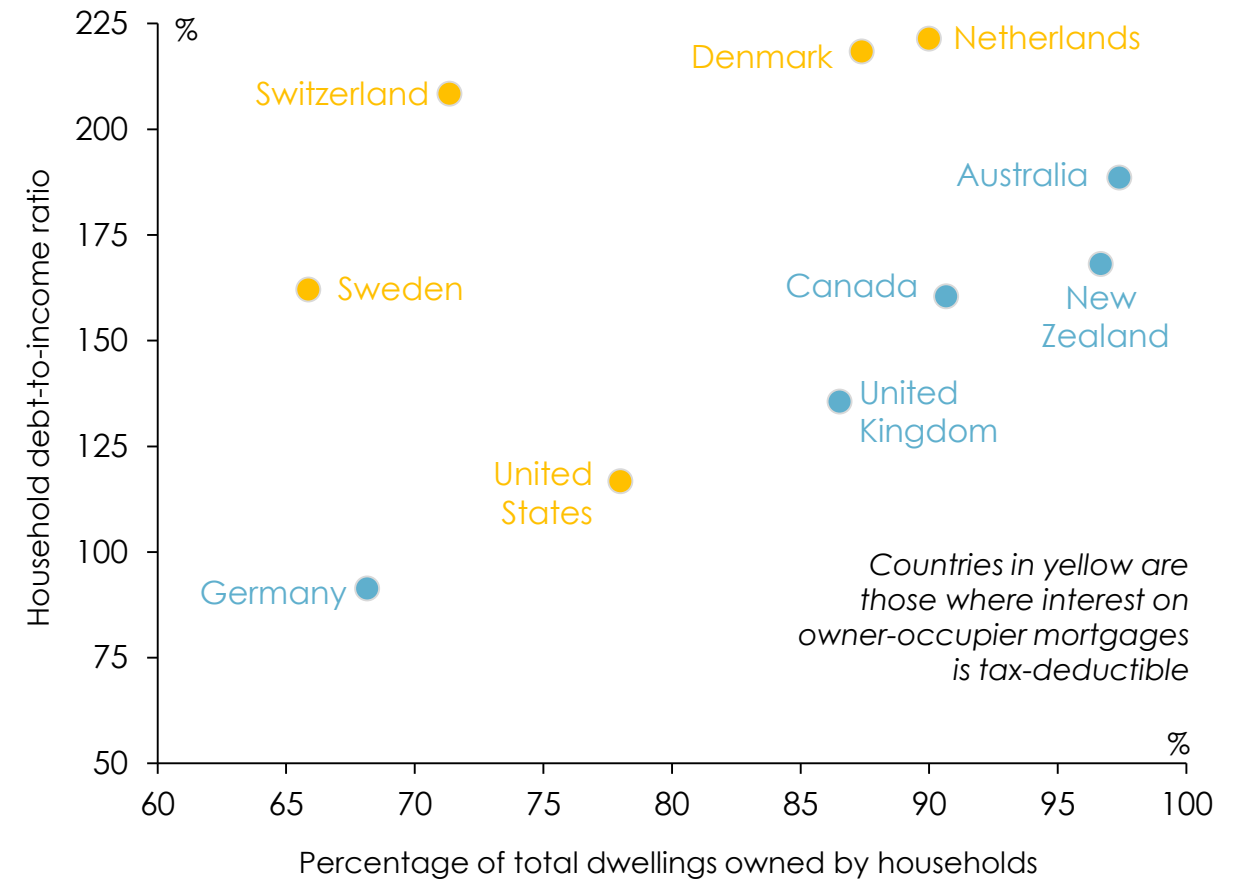
Sources: ABS; RBA.

# Australian households have among the highest debt-to-income ratios in the world – partly because they own a high proportion of the housing stock

## Household debt-to-income ratios, 'advanced' economies



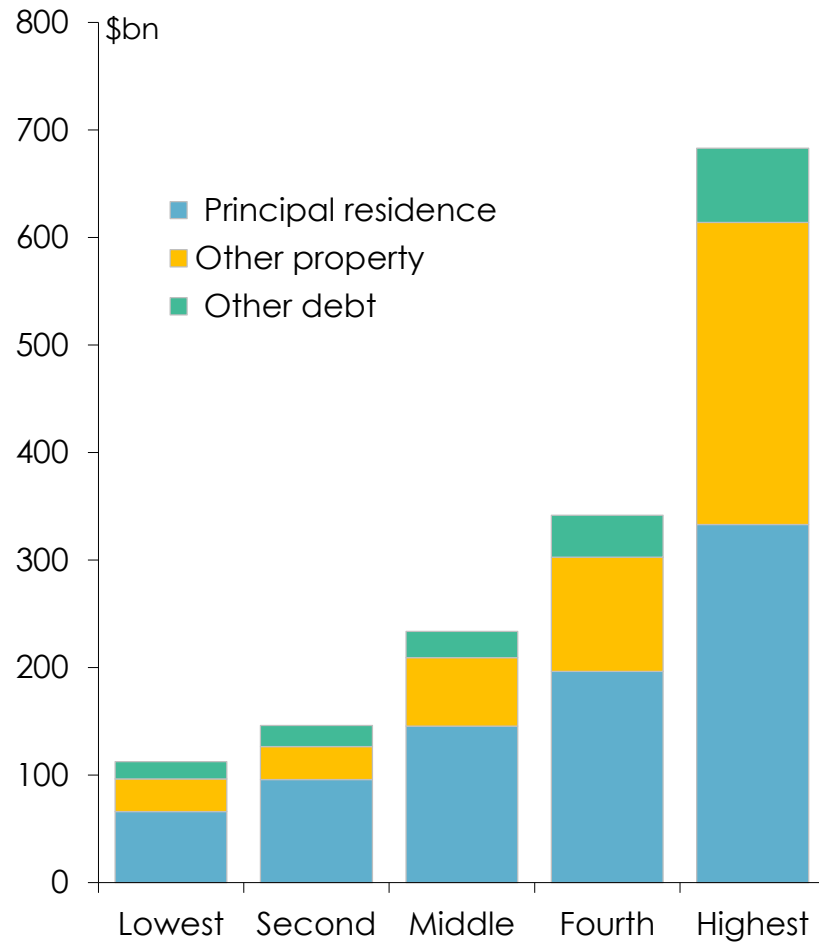
## Household debt and ownership of the housing stock



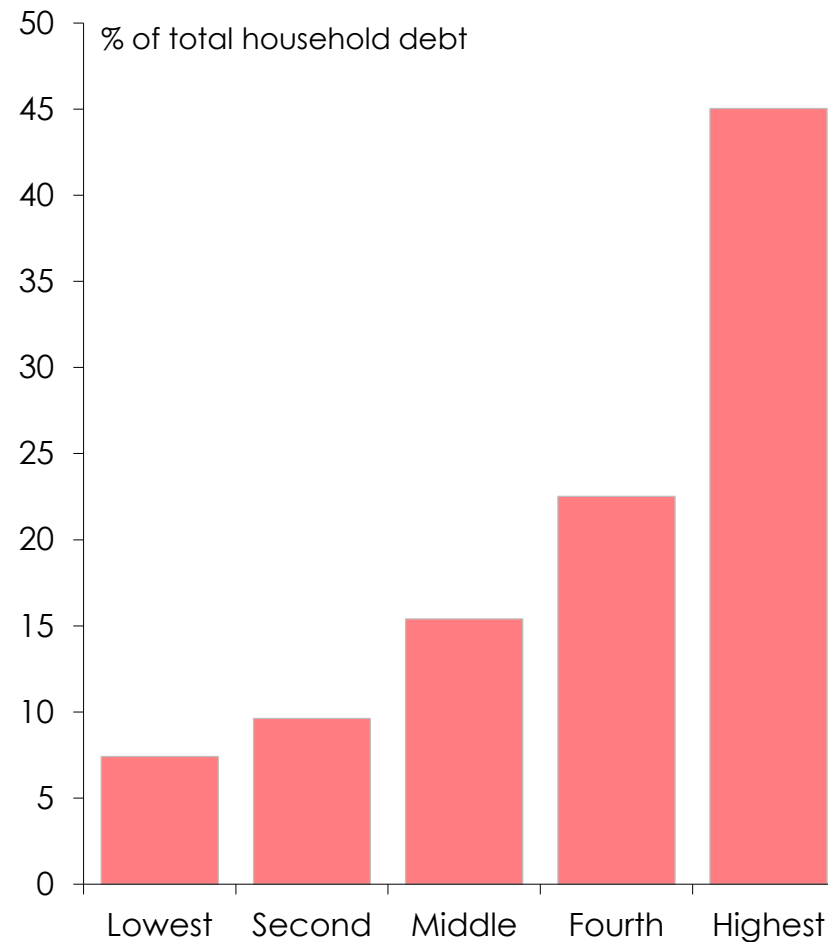
Sources: Bank for International Settlements (BIS); ABS; OECD; national statistical agencies; Michelle Bullock (Assistant Governor, RBA), 'The Evolution of Household Risks', Address to Ai Group, September 2018.

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

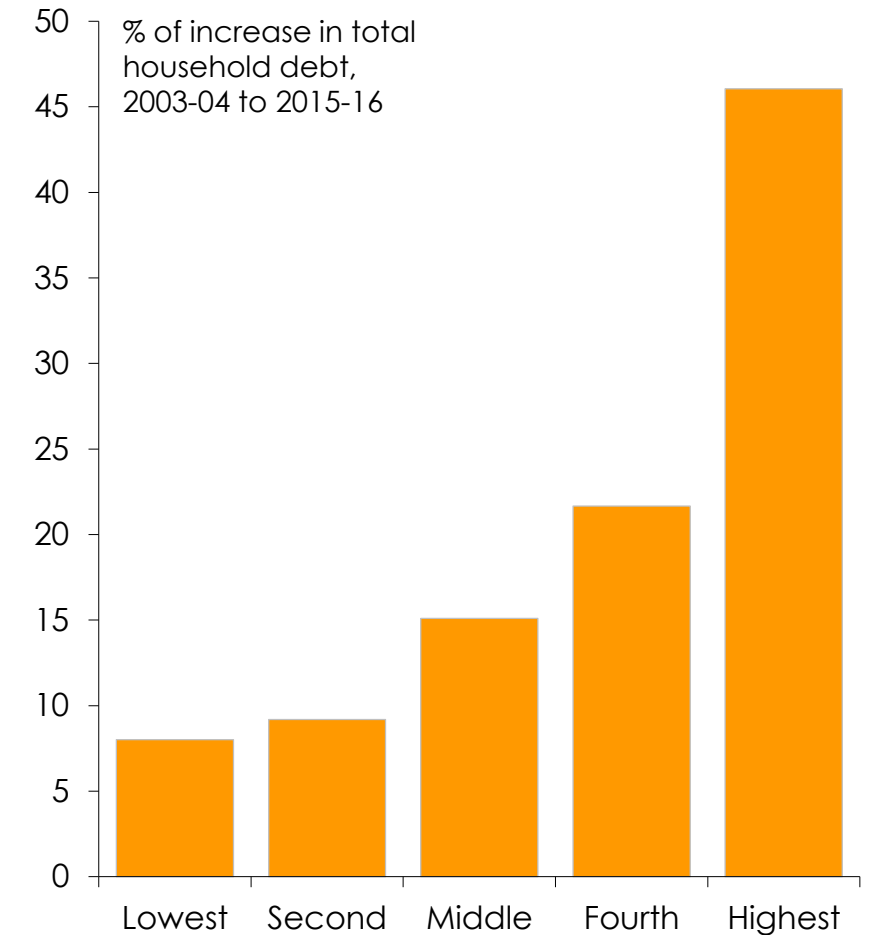
## Household debt by income quintile, 2015-16



## Share of total debt by income quintile, 2015-16



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

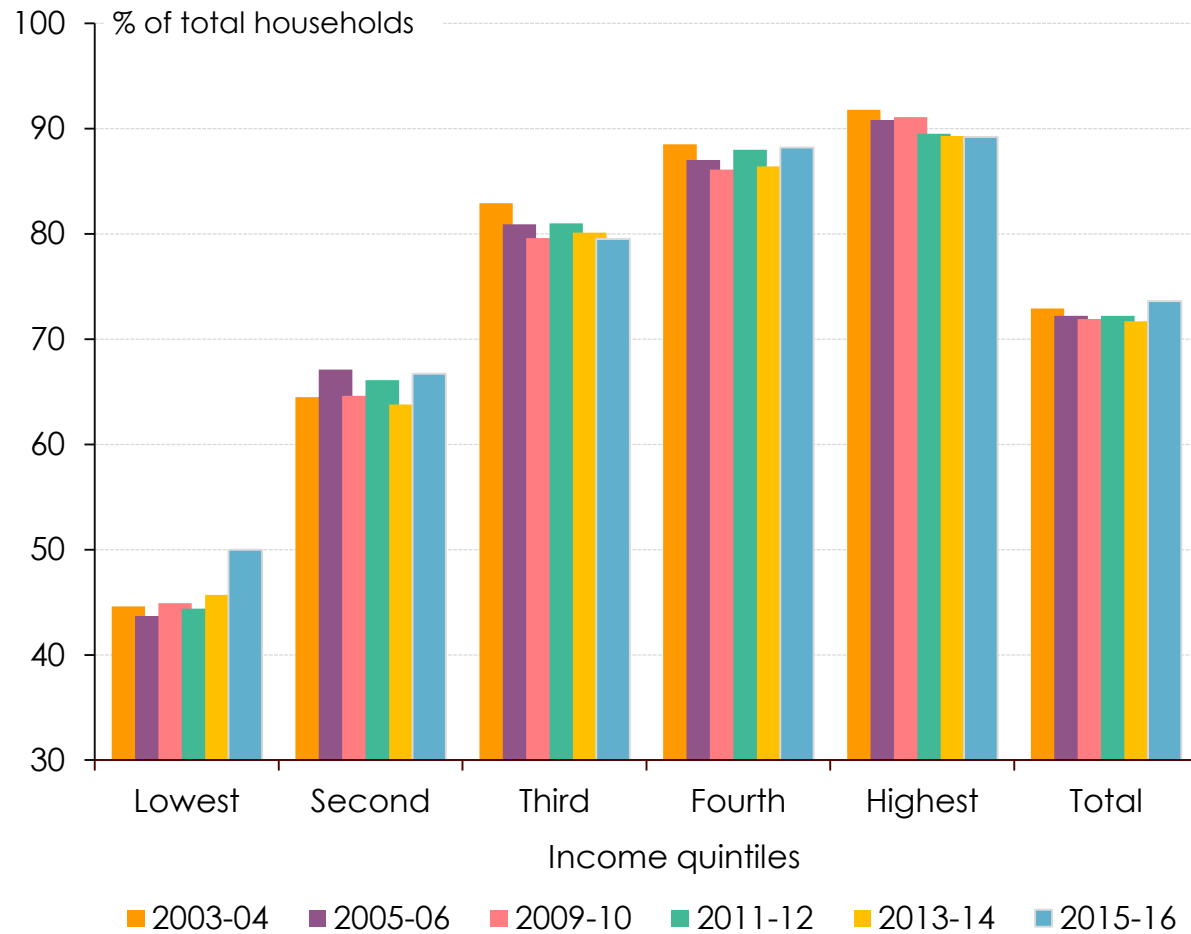


Source: ABS.

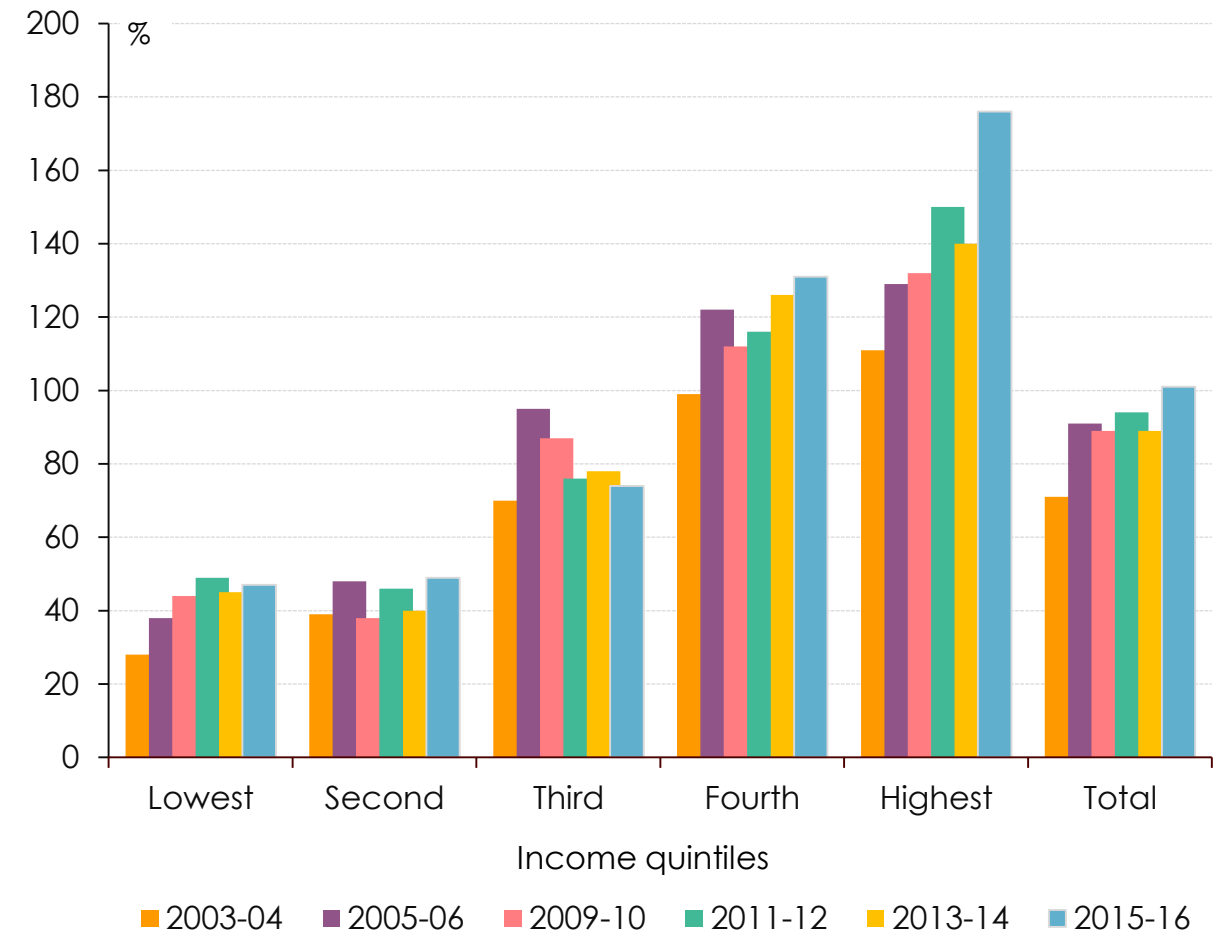


# The proportion of households who have debt hasn't changed much over the past decade – but those who do have debt have a lot more of it

## Proportion of households with debt, by disposable income quintile



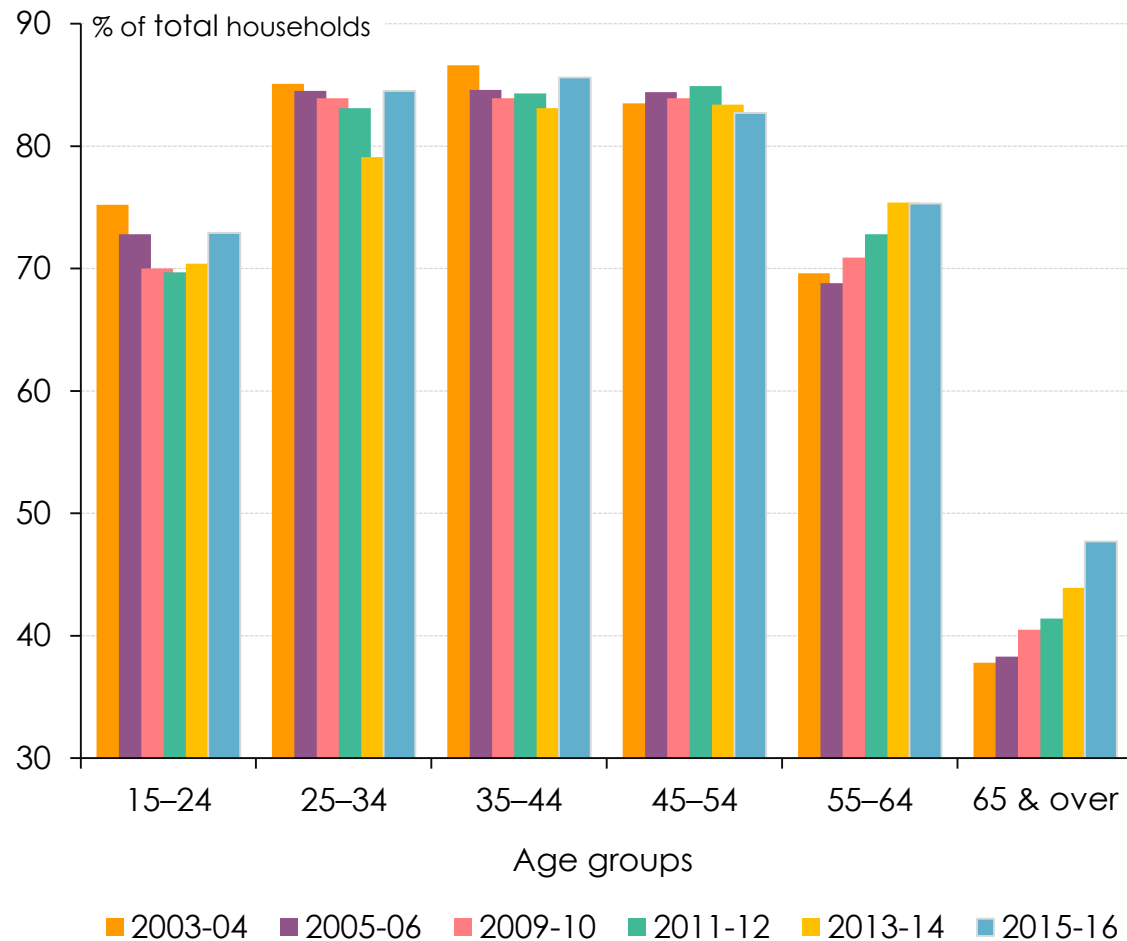
## Median debt-to-income ratio, by disposable income quintile



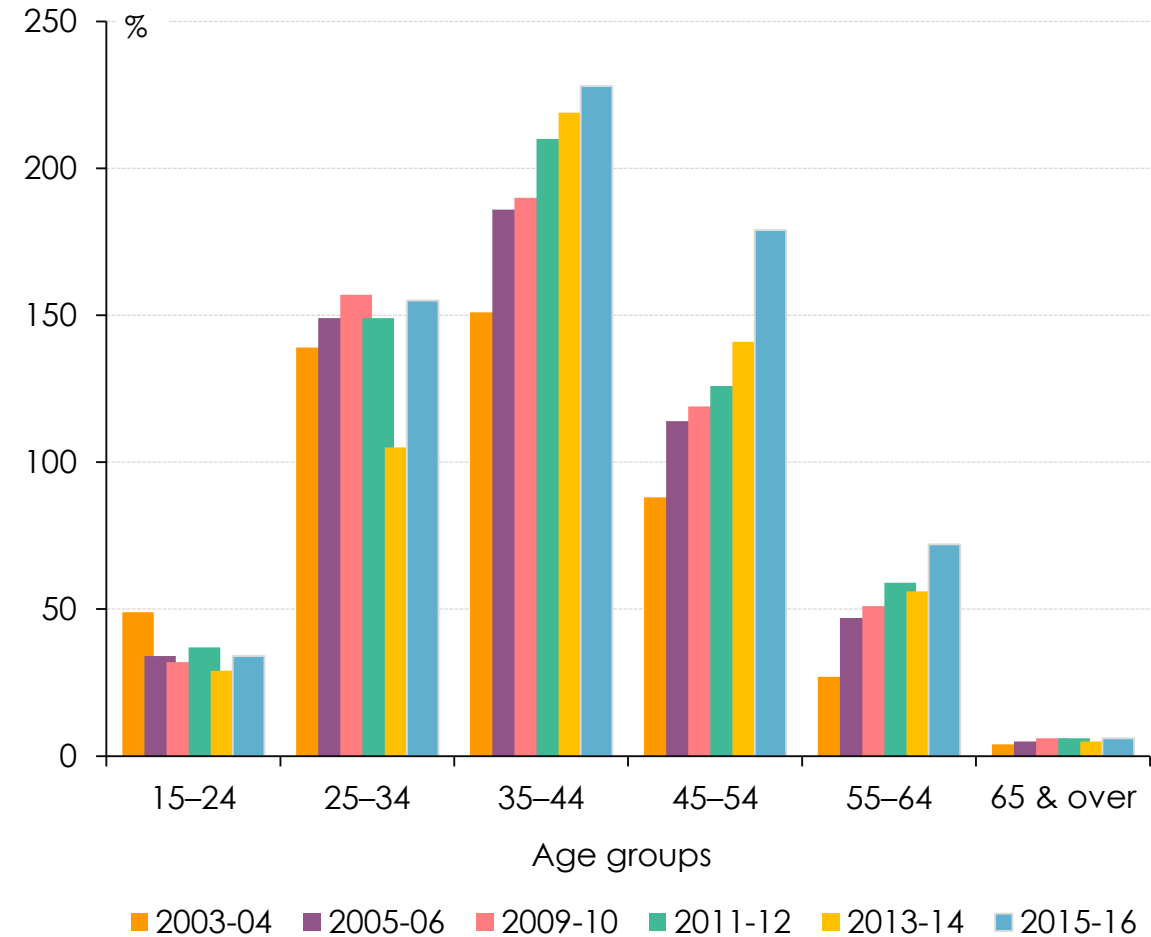
Sources: Australian Bureau of Statistics, Household Income and Wealth 2015-16 (6523.0).

# 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



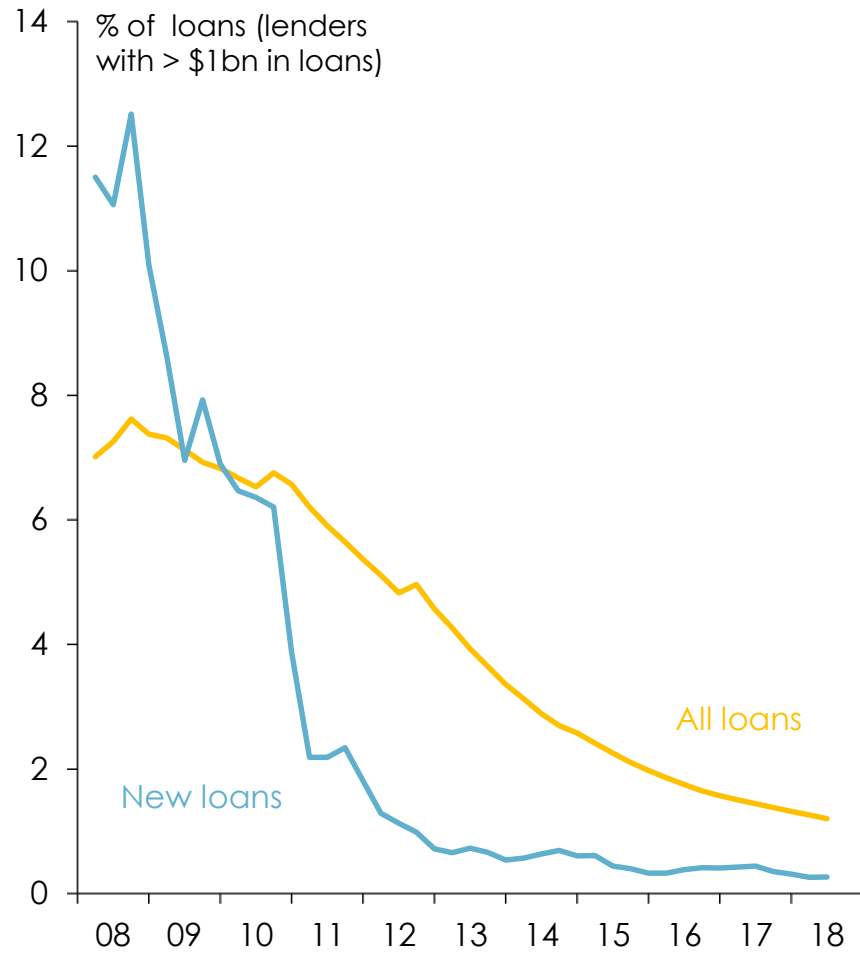
## Median debt-to-income ratio, by age group



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

# Most of the riskier forms of lending have been curtailed since the GFC – although the crack-down on interest-only loans is more recent

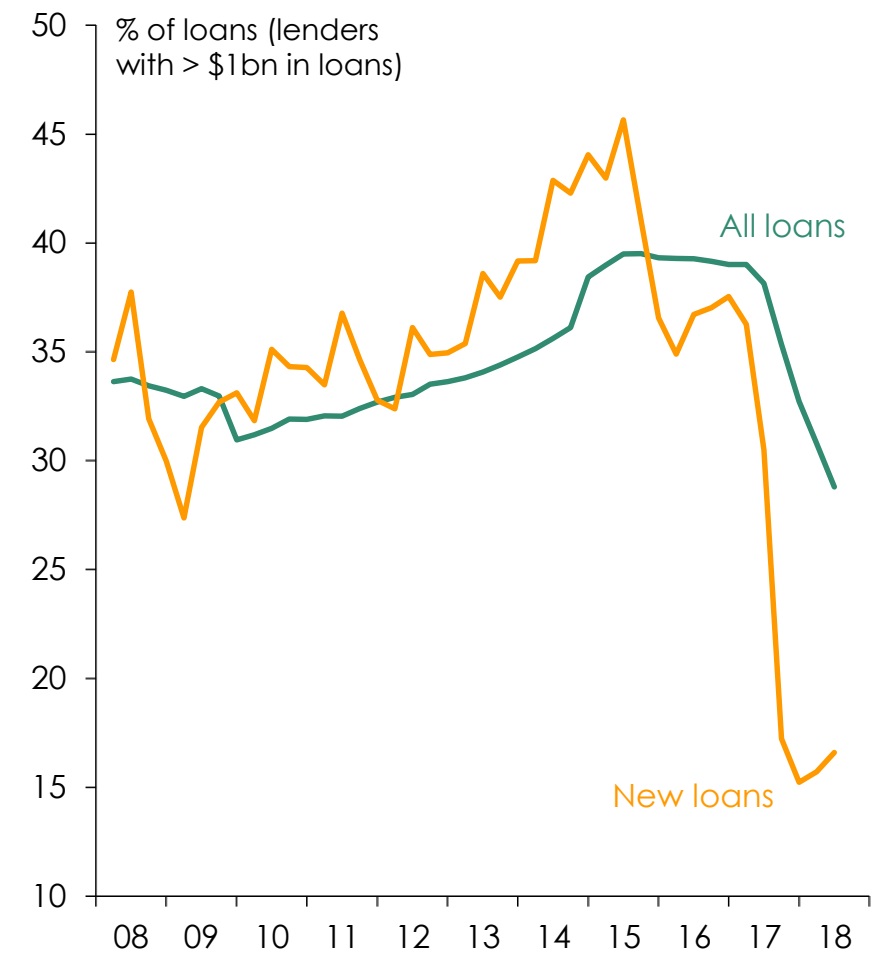
## Low-doc loans as a pc of total mortgages



## High LVR loans as a pc of new mortgages



## Interest-only loans as a pc of mortgages



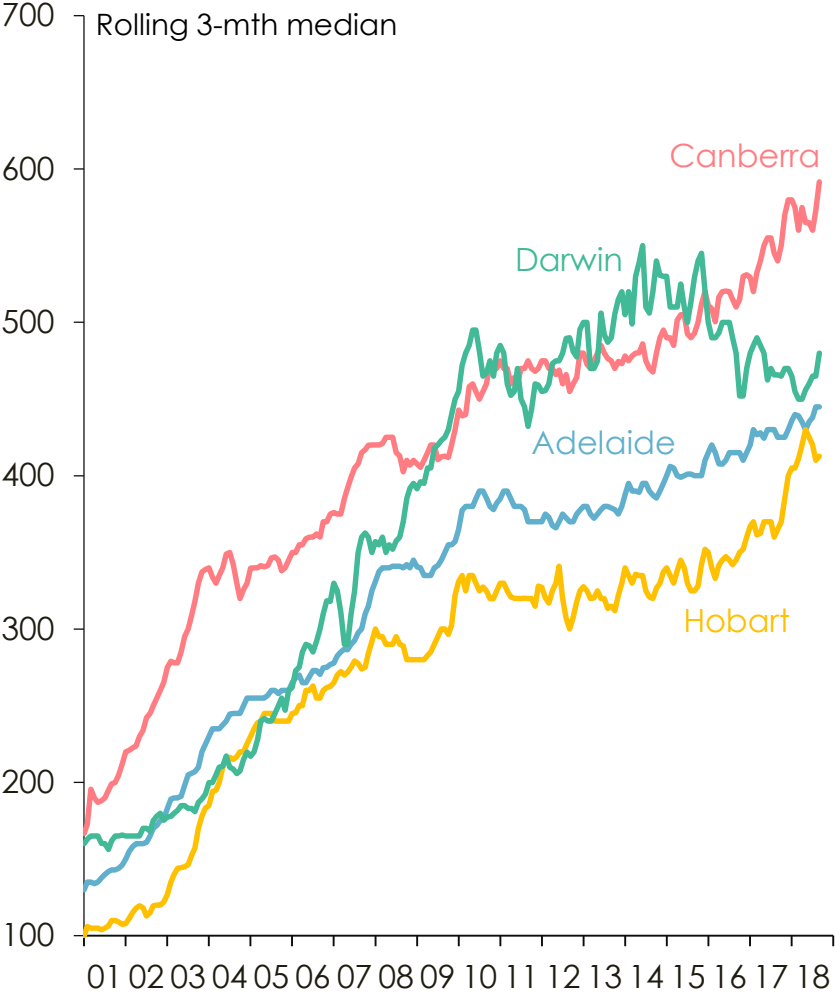
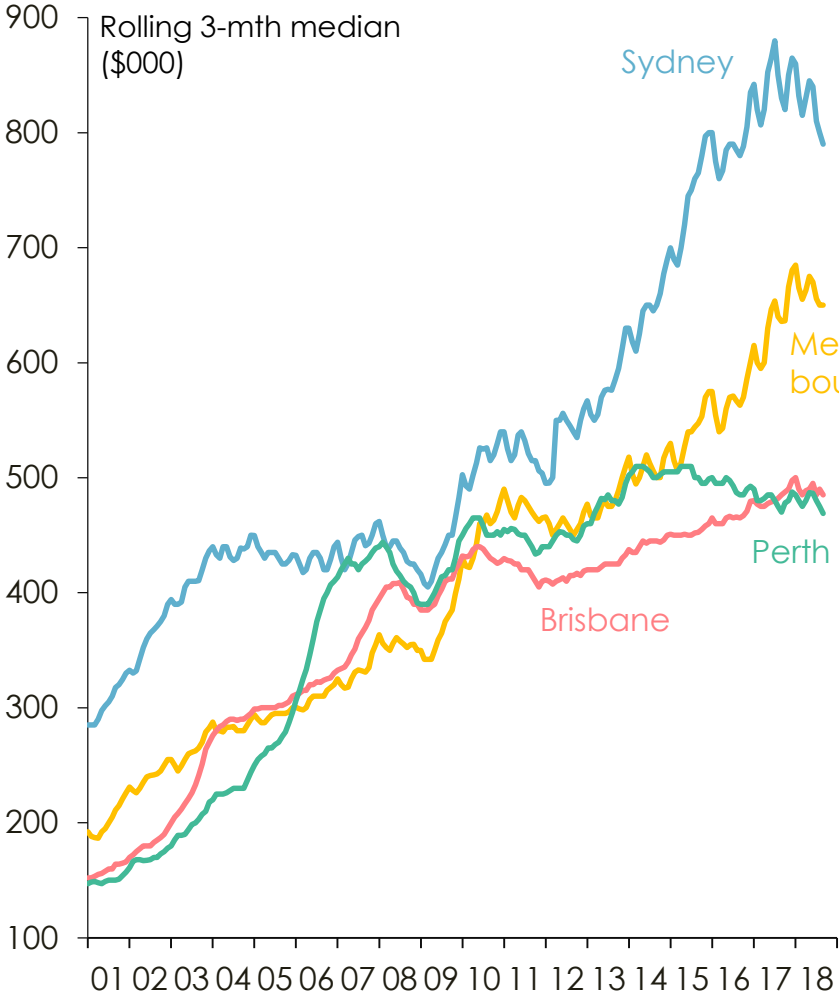
Source: Australian Prudential Regulation Authority.

# One area of potential risk noted by the RBA is borrowers transitioning from interest-only loans to principal-and-interest loans

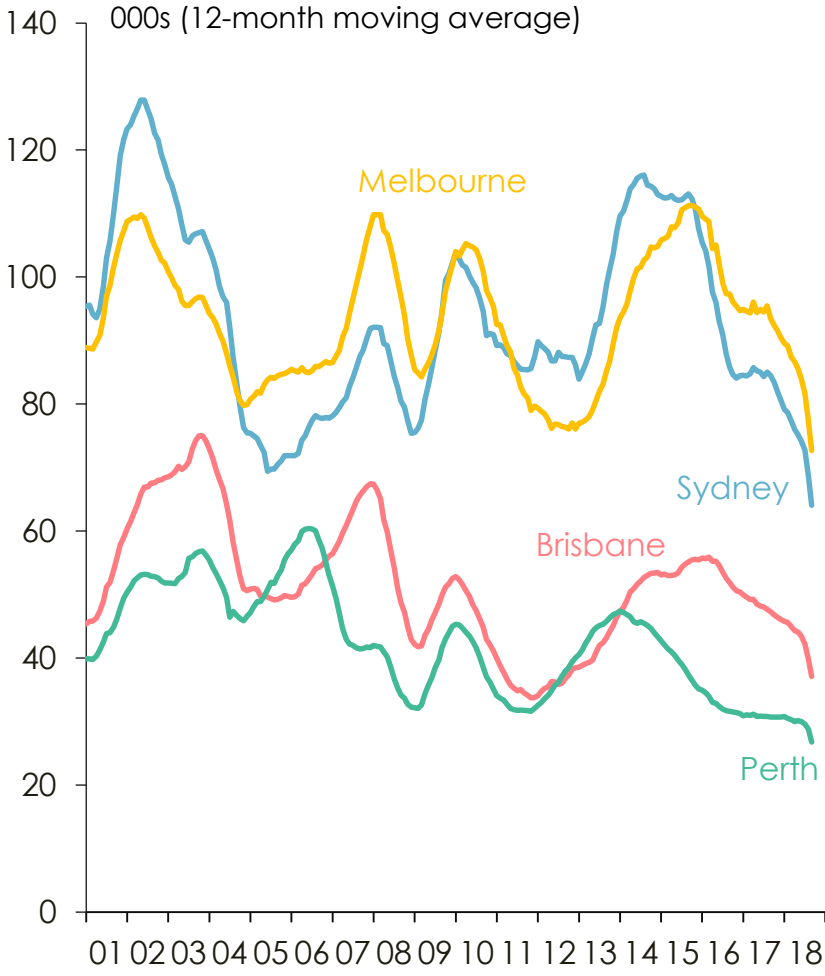
- ❑ **The RBA estimates that interest-only (IO) loans averaging about \$120bn a year are due to convert to principal-and-interest (P&I) loans between 2018 and 2021**
  - in total this represents about 30% of the total outstanding stock of mortgage debt
- ❑ **The 'step up' in mortgage payments when IO loans convert to P&I can be in the range of 30-40%**
  - even though interest rates on P&I loans are (now) typically lower than on IO loans
- ❑ **However the RBA believes that “any resulting increase in financial stress should not be widespread”**
  - many IO borrowers have accumulated substantial pre-payments on their loans
  - some borrowers have switched to P&I repayments ahead of schedule in order to avoid the higher rates which have applied to IO loans since 2016 – and “these borrowers appear well placed to handle the higher repayments”
  - the 'buffers' incorporated into the serviceability assessments used to write IO loans include potential for future interest rate increases and the step-up in payments at the end of the IO period
  - this latter aspect of loan serviceability standards was tightened by APRA in 2014
- ❑ **The RBA believes that “the share of borrowers who cannot afford higher P&I repayments and are not eligible to alleviate their situation by refinancing is ... small”**
  - and “most would be expected to have positive equity given substantial housing price growth in many parts of the country over recent years and hence would at least have the option to sell the property if they experienced financial stress from the increase in repayments”
- ❑ **Overall, the RBA says that “regulatory measures and broader strengthening of lending standards have contributed to an improvement in the risk profile of new housing lending and the resilience of household balance sheets”**

# Capital city residential property markets appear in most cases to have peaked

## Capital city median dwelling sale prices



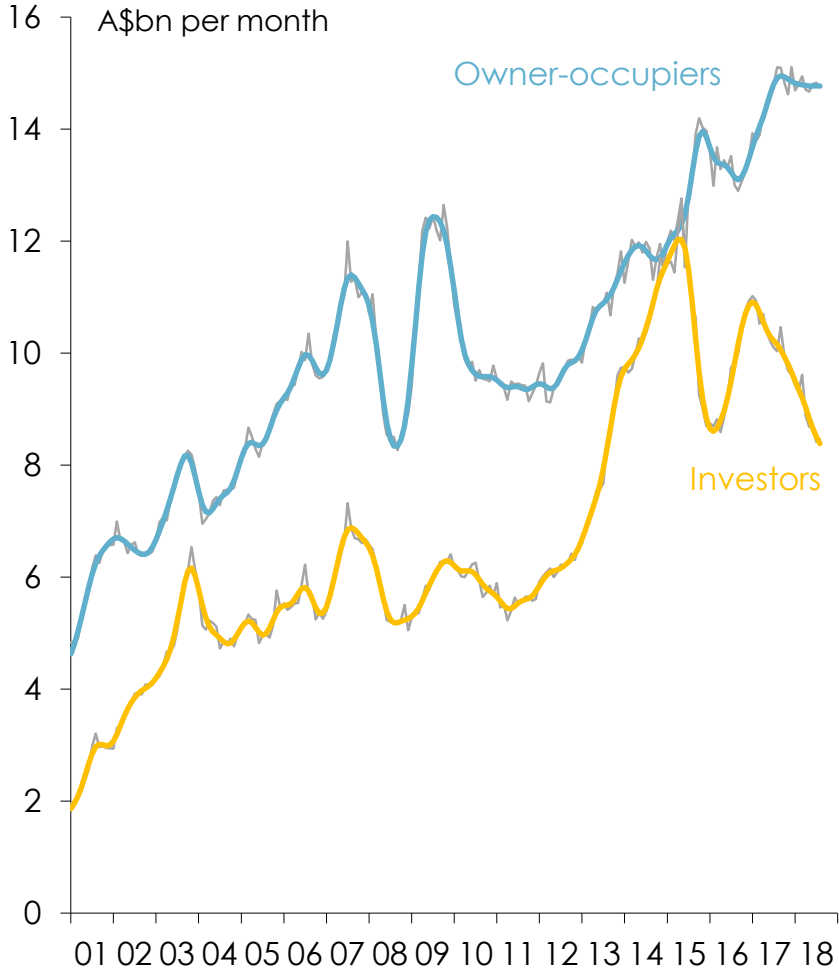
## Sales volumes



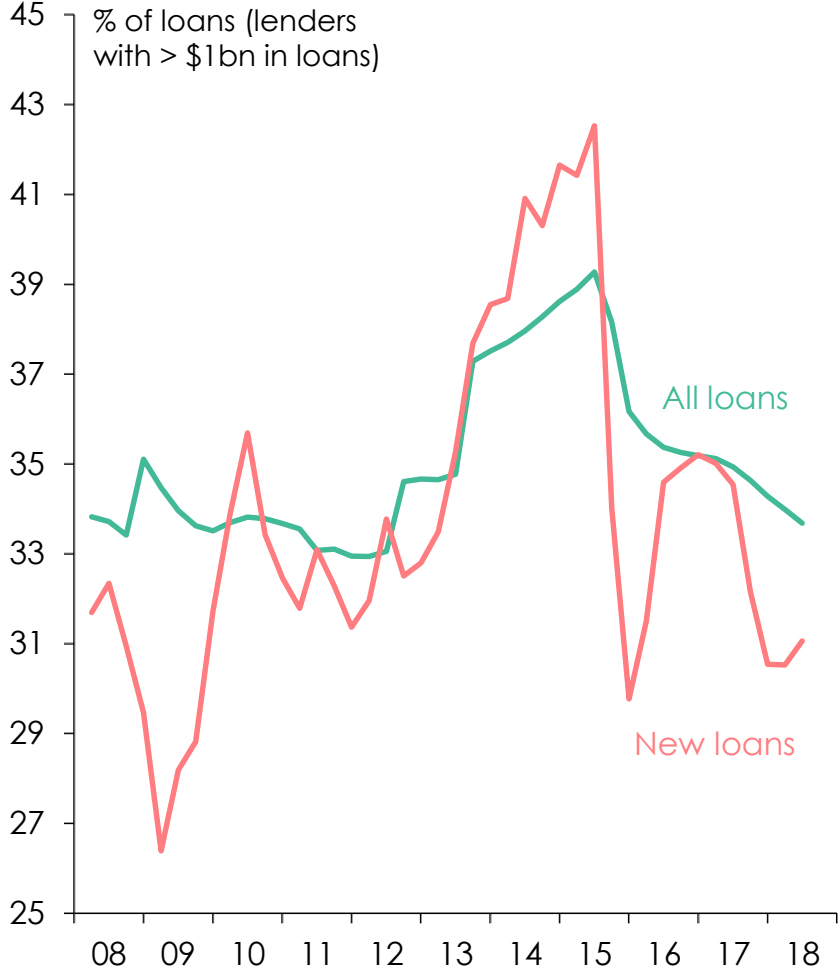
Source: CoreLogic.

# The softening in residential property markets largely reflects weaker demand from investors – including foreign investors

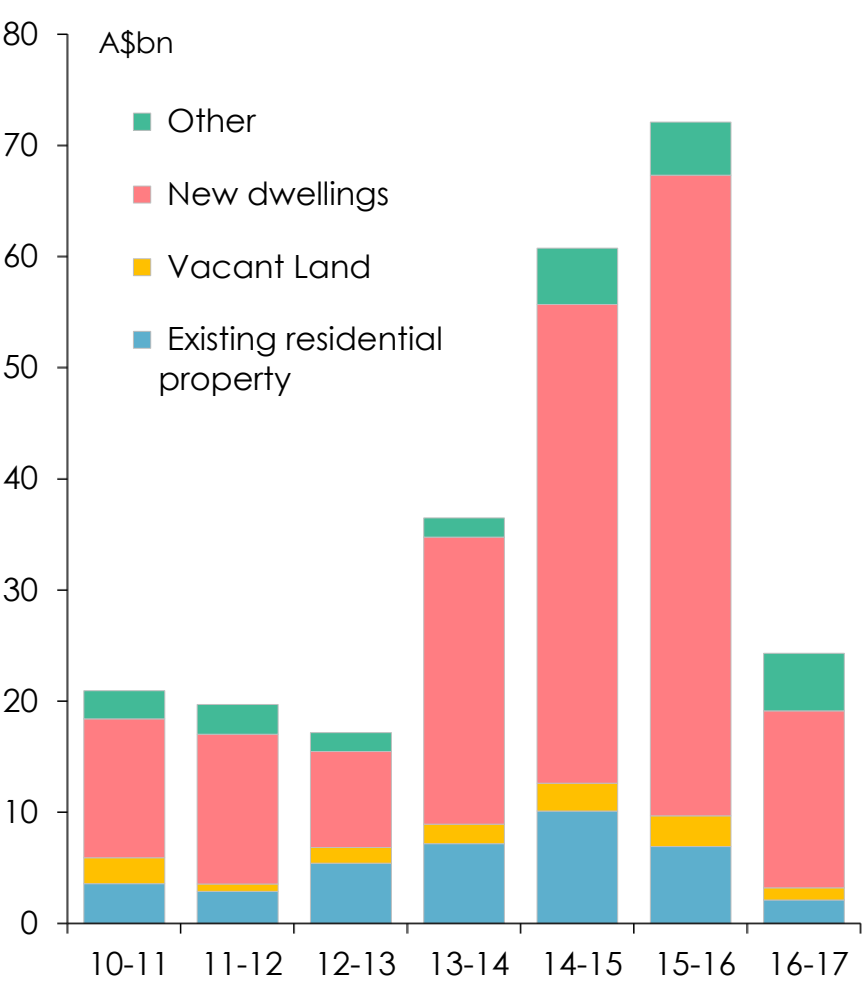
### Housing finance commitments by type of borrower



### Lending to property investors as a pc of total



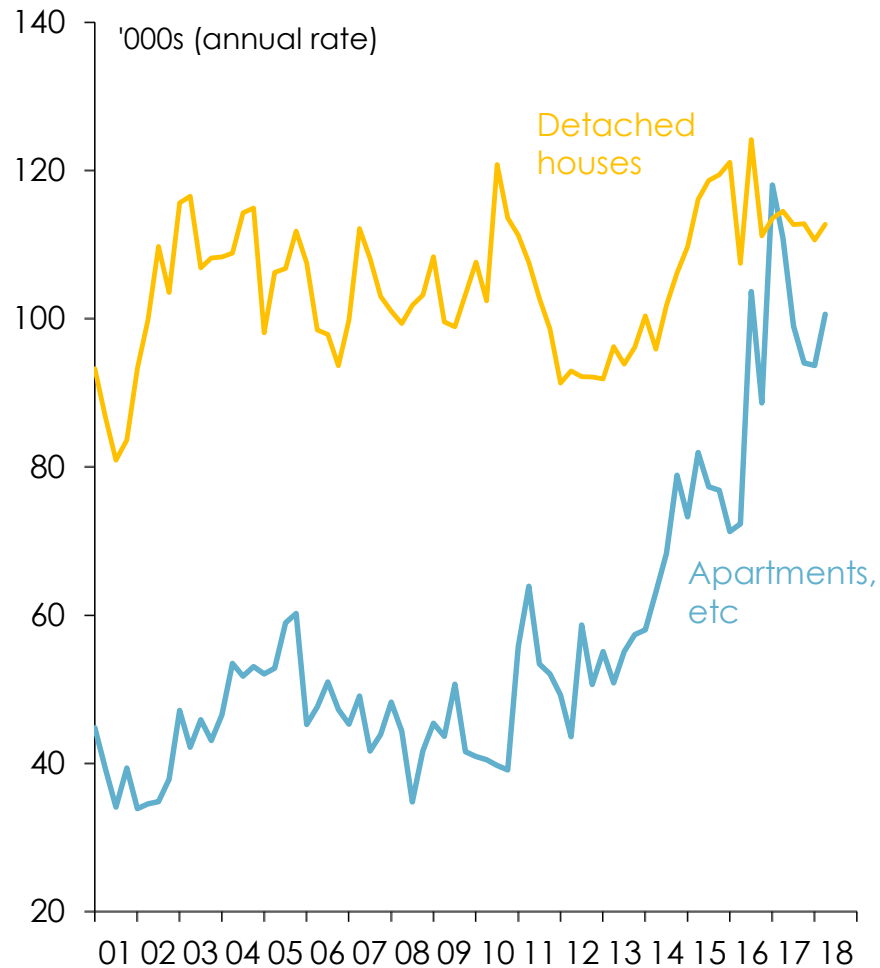
### FIRB approvals for investment in residential real estate



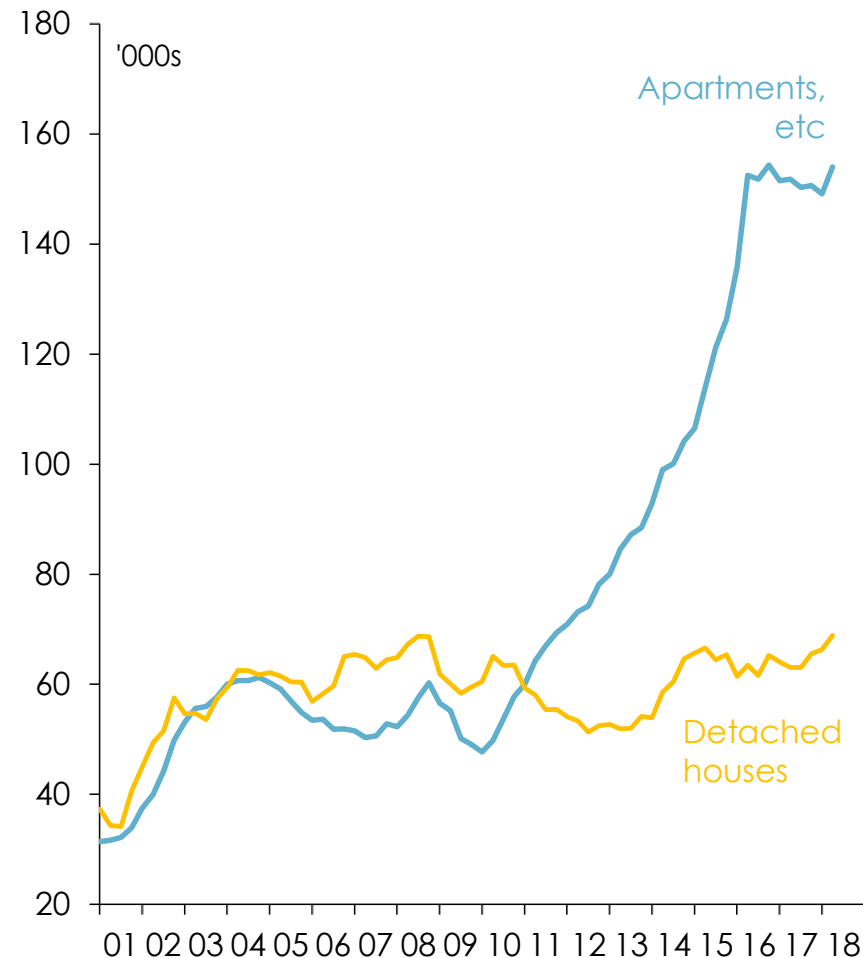
Sources: ABS; APRA; Foreign Investment Review Board.

# Increased housing supply is also likely to exert some downward pressure on property prices – but mainly for apartments, not houses

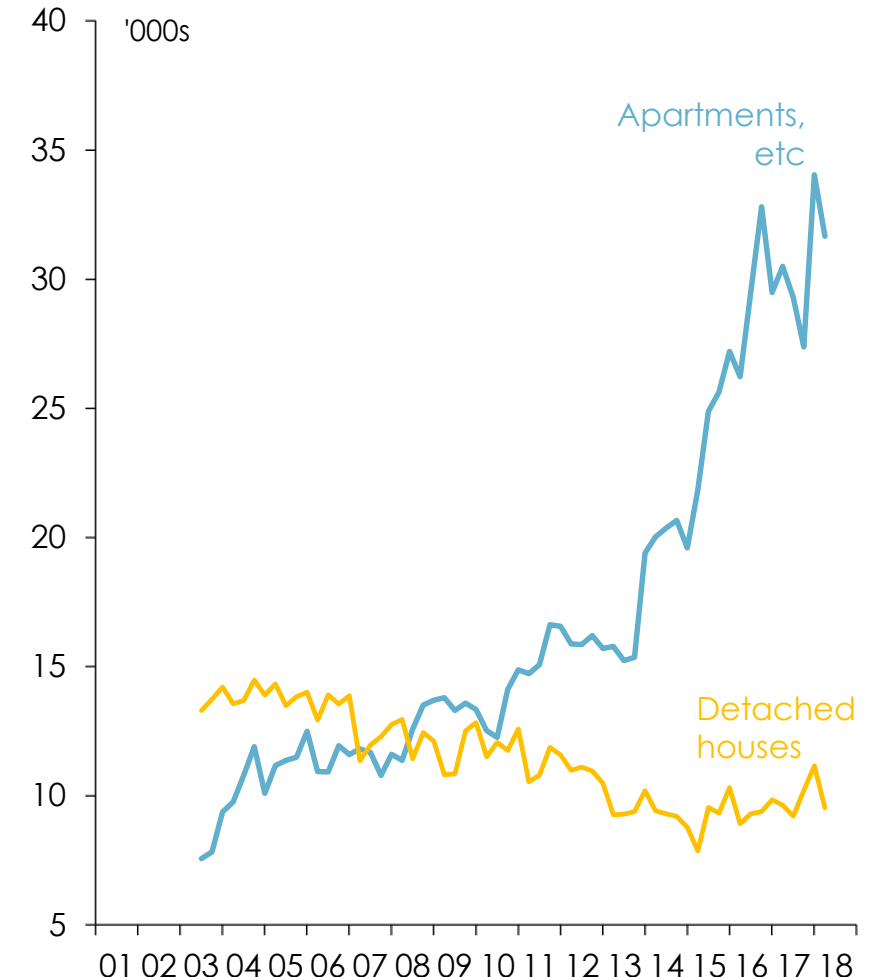
## Housing completions



## Housing commencements



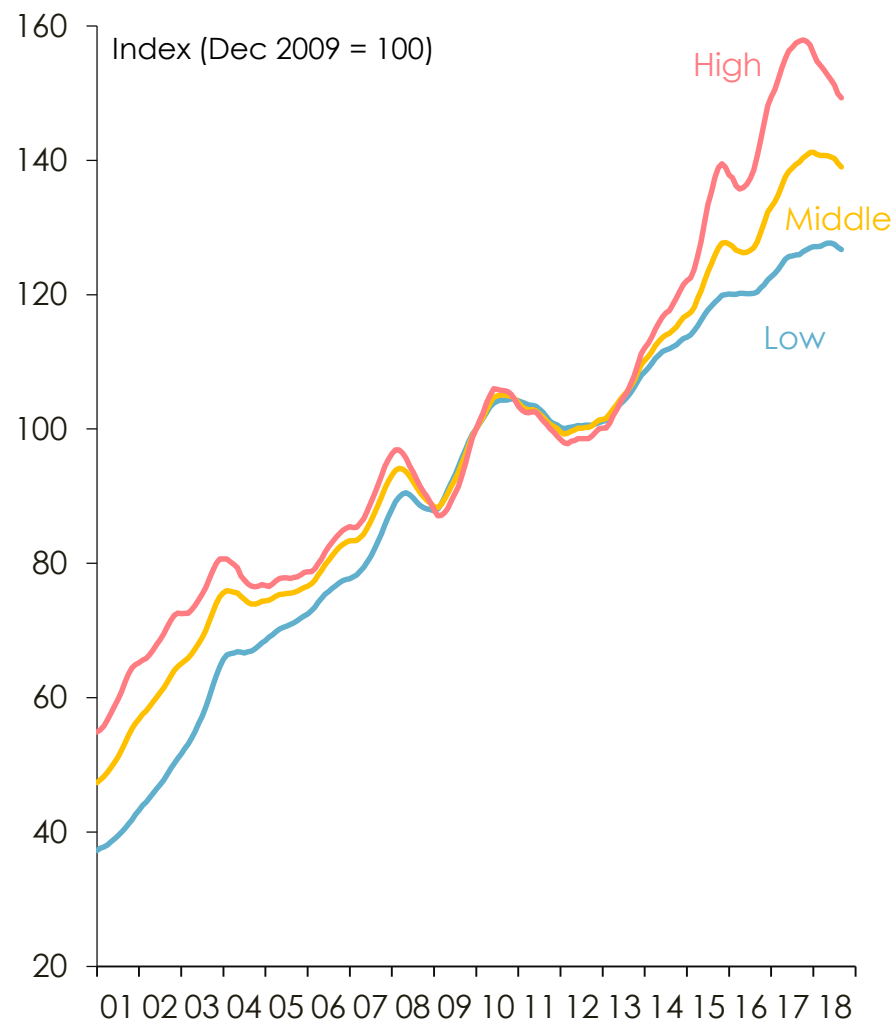
## Housing approved but not yet commenced



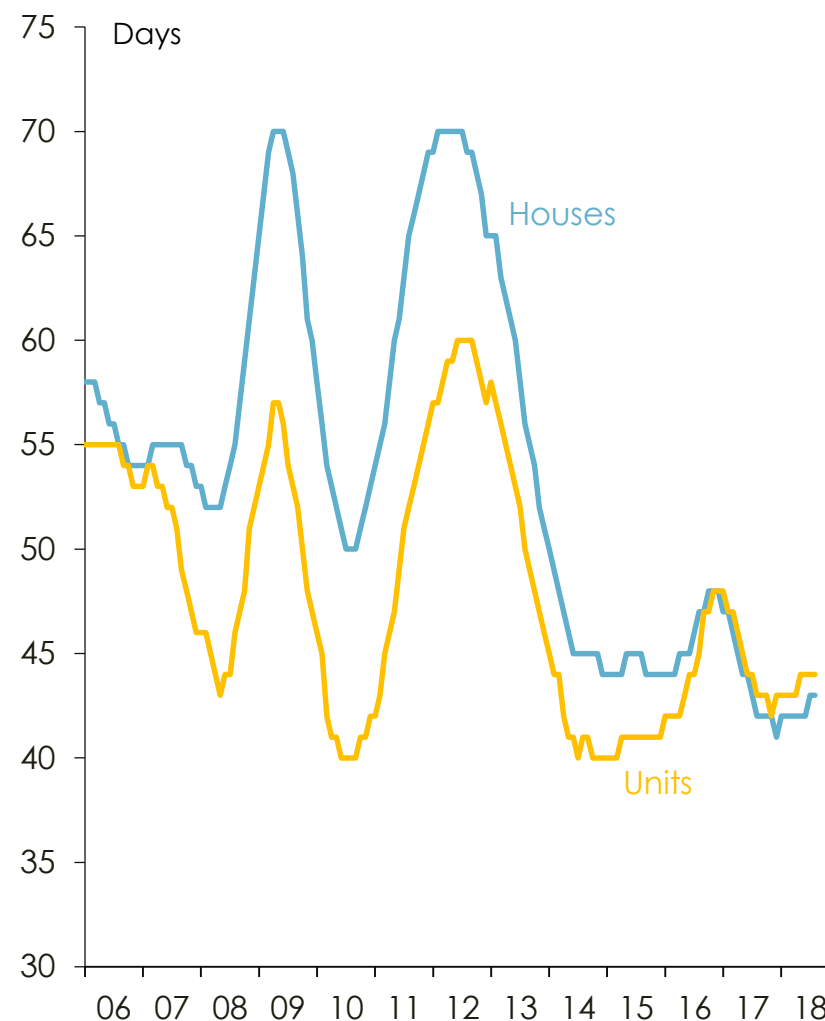
Source: ABS.

# Price declines have been concentrated at the top end of the market – and there’s no evidence of widespread forced or panic selling

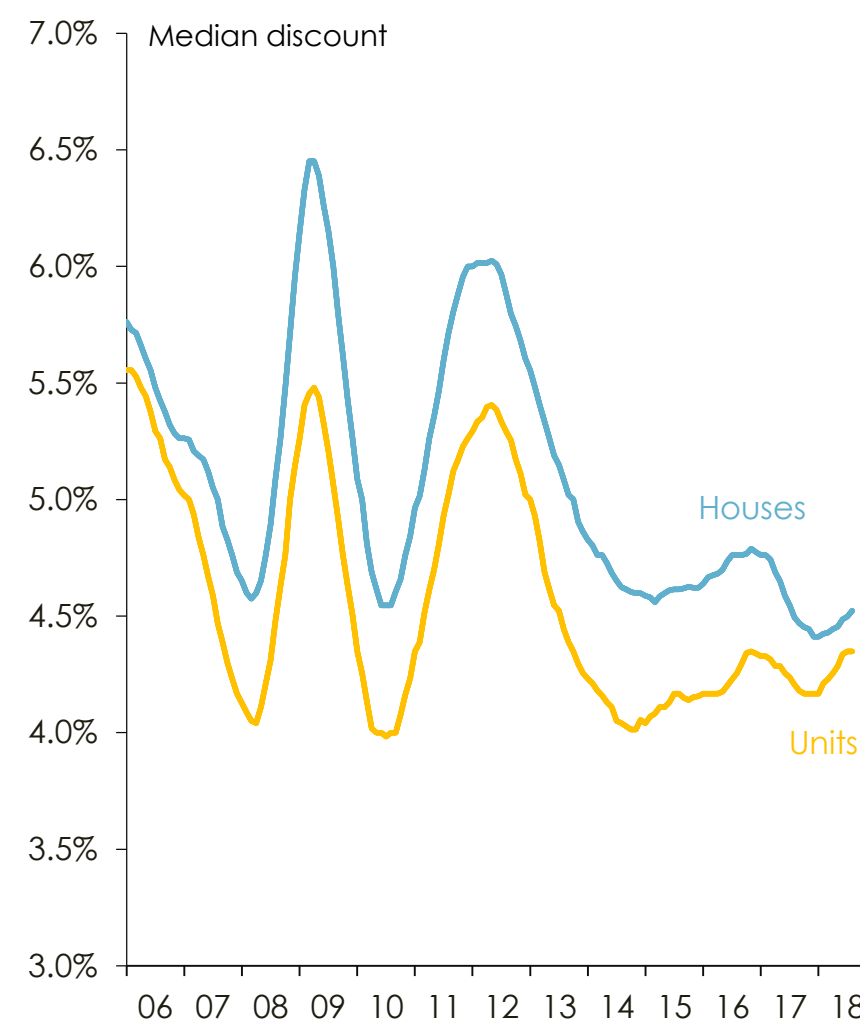
## Home values by ‘tier’



## Median time on the market



## Vendor discounting

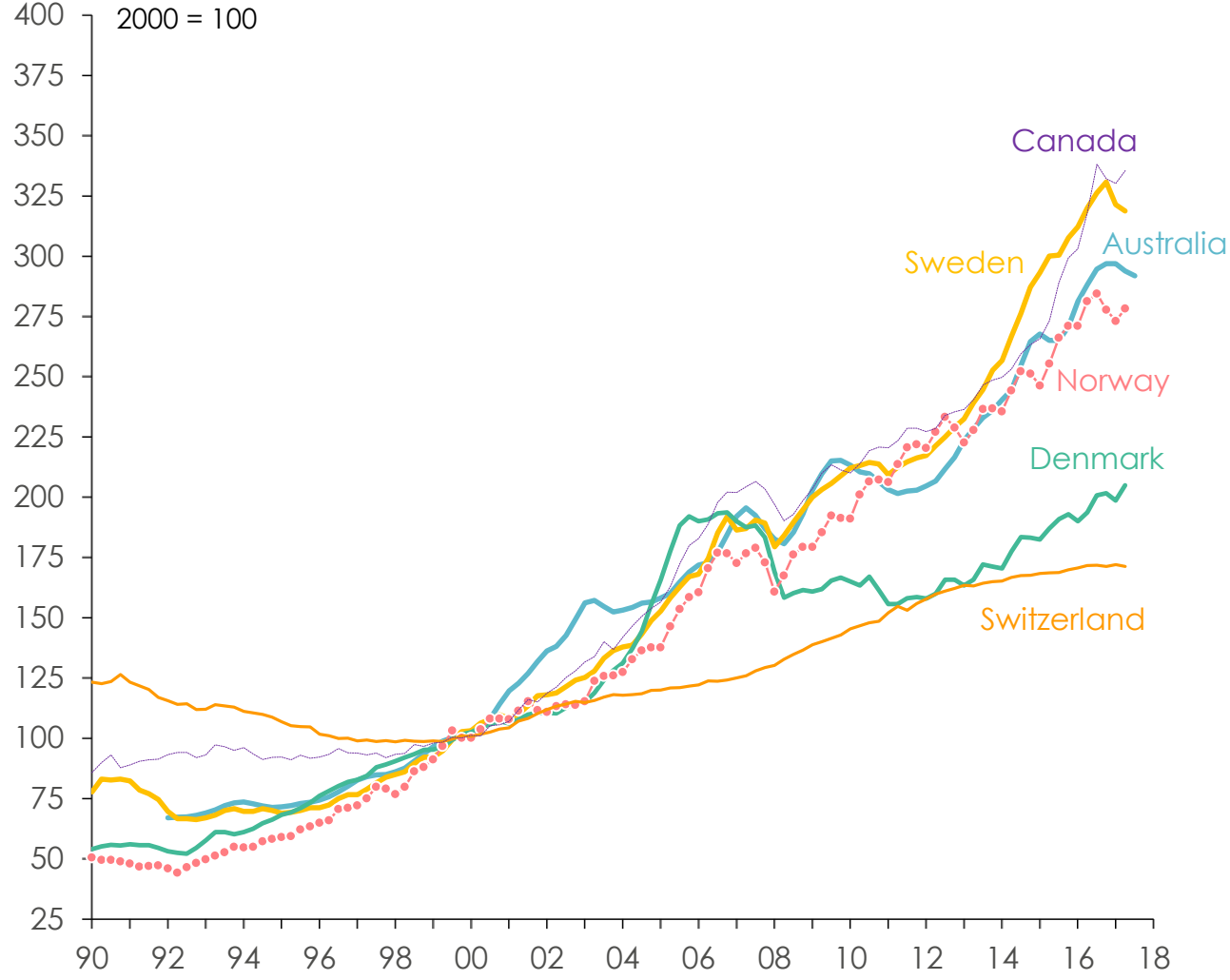
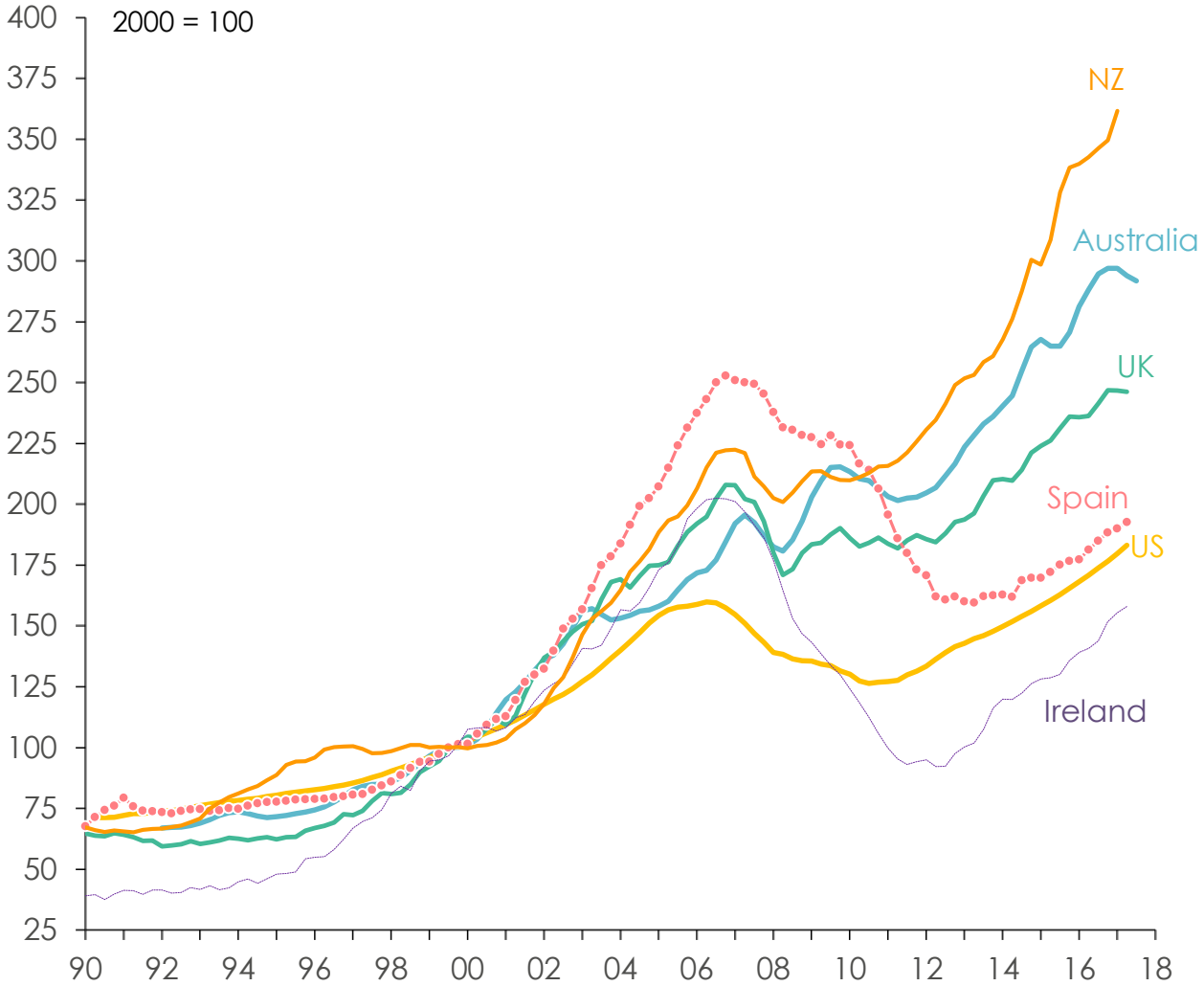


Note: The low, medium and top tiers measure the underlying sales value of the properties making up the bottom 25%, middle 50% and top 25%, respectively. Note that these are hedonic value indexes (that is, they control for structural and locational characteristics of different properties) rather than prices. Source: CoreLogic.



# 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

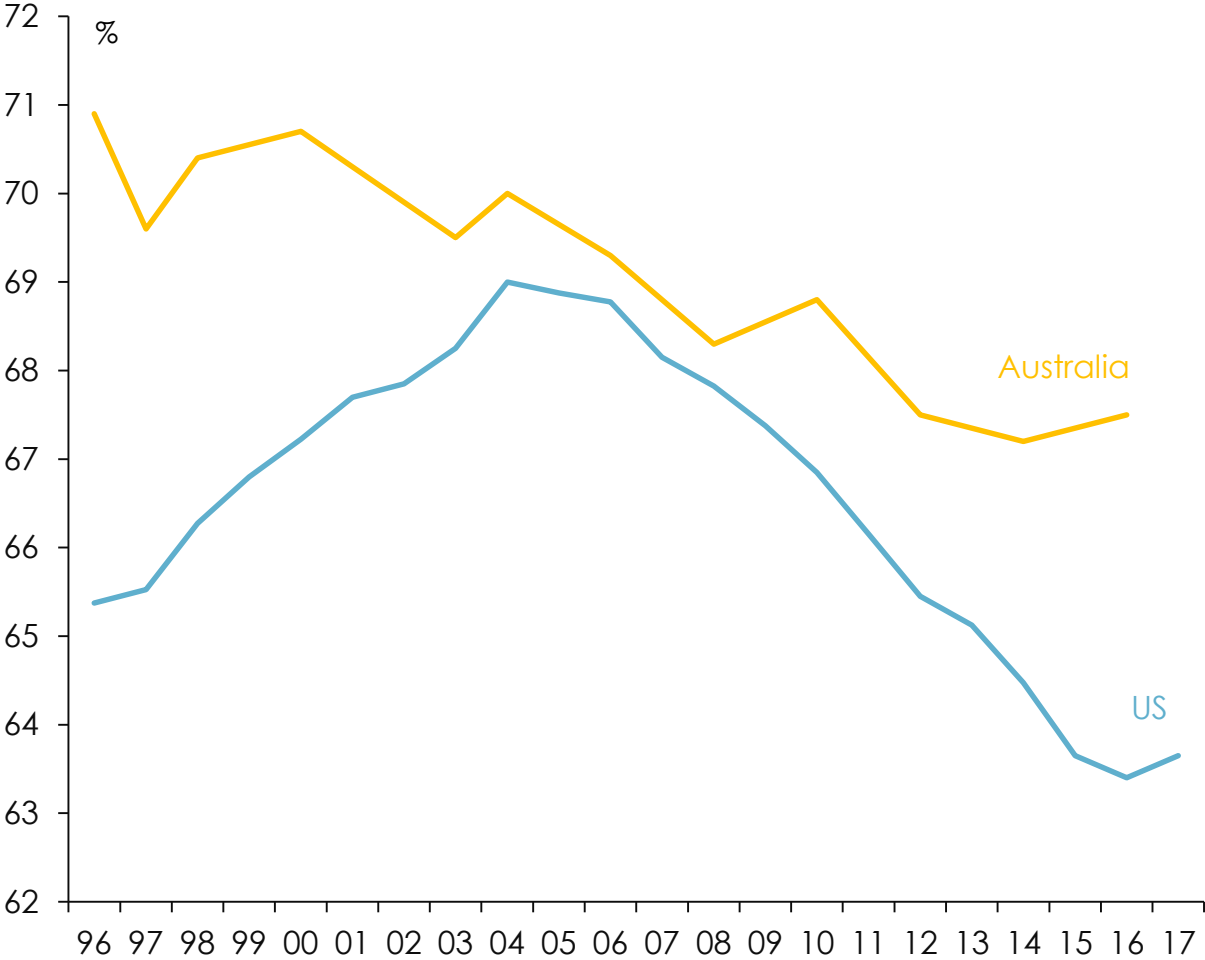
## Residential property prices – Australia and other 'advanced' economies



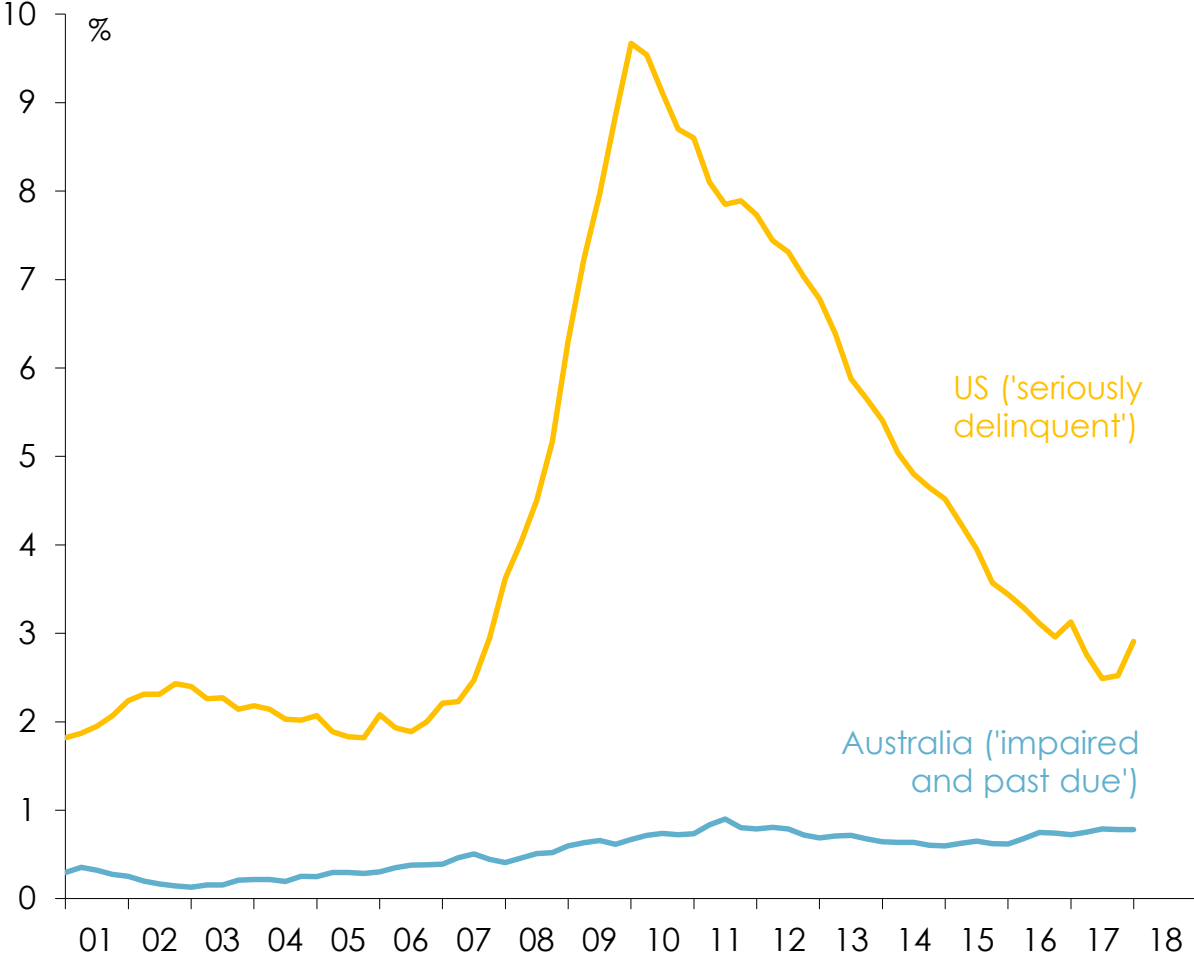
Source: CoreLogic; Bank for International Settlements.

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

### Home ownership rates, US and Australia



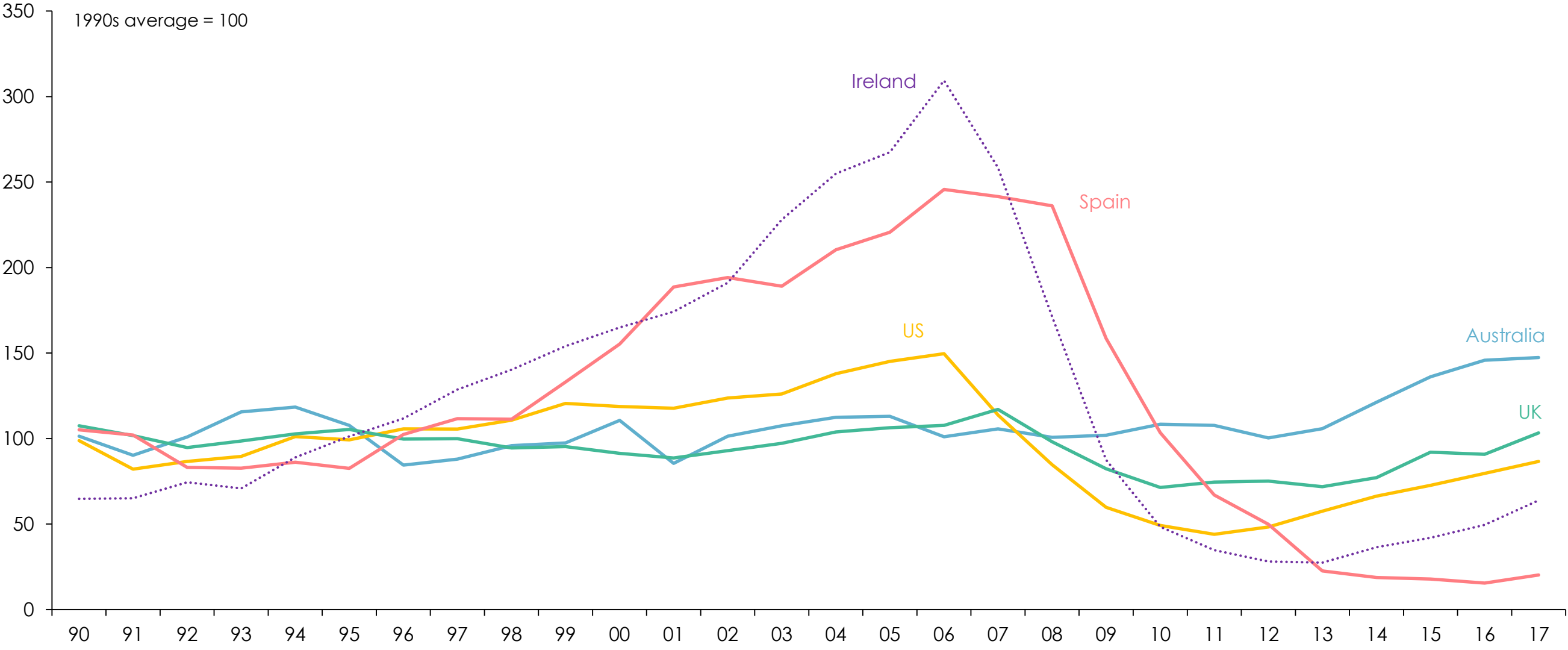
### Mortgage delinquency rates, US and Australia



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

# ... and they're unlikely 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



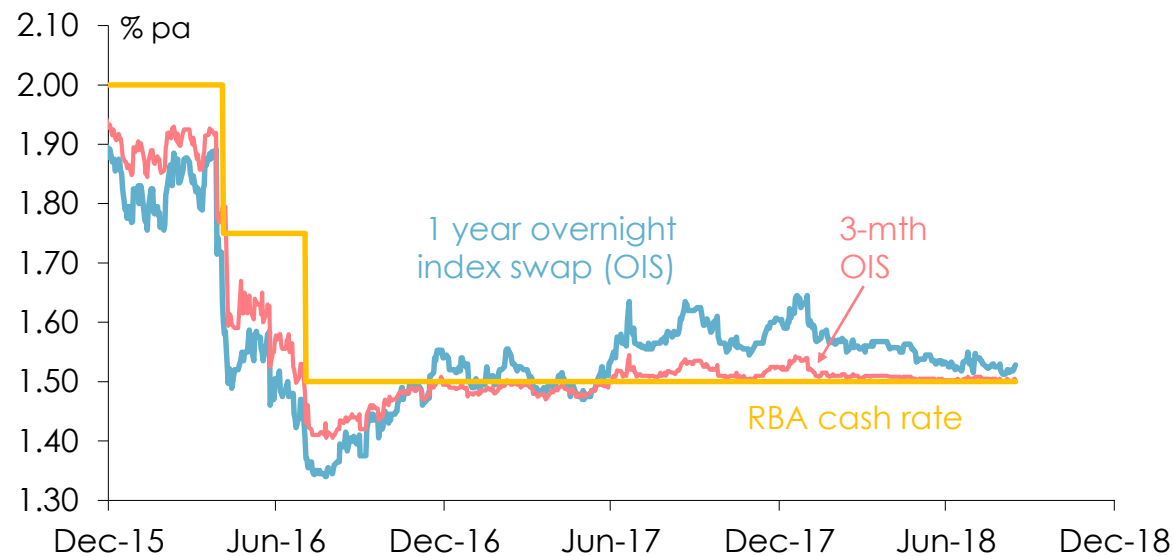
Sources: Australian Bureau of Statistics; US Commerce Department; UK Office of National Statistics; Instituto Nacional de Estadística d'España; Ireland Central Statistics Office.

# The RBA is in no hurry to begin lifting official interest rates, no matter what other central banks do

## RBA forecasts

	Year-ended					
	Jun 2018	Dec 2018	Jun 2019	Dec 2019	Jun 2020	Dec 2020
GDP growth	3	3¼	3¼	3¼	3	3
Unemployment rate <sup>(b)</sup>	5.5	5½	5¼	5¼	5¼	5
CPI inflation	2.1	1¾	2	2¼	2¼	2¼
Underlying inflation	2	1¾	2	2	2¼	2¼

## Market pricing of the RBA cash rate



Source: RBA, Statement on Monetary Policy, August 2018.

- ❑ The RBA expects economic growth to be ‘a bit above trend’ this year and next – making for ‘a further gradual decline in the unemployment rate’, but not reaching 5% until 2020 ...
- ❑ ... while progress in ‘having inflation return to target is expected ... to be gradual’
- ❑ These are not the forecasts of a central bank that is on the cusp of tightening monetary policy
- ❑ The RBA takes movements in interest rates charged by lenders into account when contemplating movements in its own cash rate – and at its last meeting noted that ‘the average mortgage rate is lower than a year ago’ despite ‘some lenders’ increasing ‘rates by small amounts
- ❑ The RBA would be delighted to see [further] increases in foreign interest rates while it ‘stands pat’ reflected in a further decline in the A\$
- ❑ Financial markets and economists have been pushing out their expectations for the timing of the first increase in the RBA cash rate – it may well not be until the second half of next year, or even the first half of 2020

# Summary

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- ❑ **Australia's overall economic growth rate has picked up over the past year**
  - but it's been disproportionately based on population growth, and resources exports
  - excluding the contribution of population growth Australia's economic growth rate since 2013 has been quite ordinary
- ❑ **Unemployment (and under-employment) remains uncomfortably high, while both price and wage inflation remain uncomfortably low**
  - by contrast, in a growing number of other 'advanced' economies unemployment is below 'full employment' levels, and inflation is getting closer to central bank targets
- ❑ **Australian households have been reducing their saving in order to maintain spending levels in the face of stagnating real incomes**
  - but their capacity to keep doing that may be coming to an end
- ❑ **The decline in residential property prices now under way in most parts of Australia will likely make households more cautious about spending, at least until income growth begins to pick up**
- ❑ **Although Australian households are (in aggregate) carrying a lot of debt, their debt servicing capacity remains high (and the likelihood of widespread defaults remains low)**
  - provided, of course, that interest rates don't rise sharply
  - and there's no reason to think that they will
- ❑ **Property prices are likely to continue declining, but the probability of a big 'housing bust' is still quite low**
- ❑ **The biggest risks to the Australian economy, Australian households and the Australian financial system are more likely to come from overseas, not at home**