Philip Lowe: Remarks at Reserve Bank Board Dinner

Remarks by Mr Philip Lowe, Governor of the Reserve Bank of Australia, Reserve Bank Board Dinner, Melbourne, 4 April 2017.

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Good evening.

On behalf of the Reserve Bank Board I would like to warmly welcome you all to this dinner.

We are very pleased that leaders from the worlds of politics, academia and the community sector, as well as from business, have been able to join us tonight. Having leaders join us from right across the community is important to us, as the decisions made by the Reserve Bank Board and by the Bank affect all Australians. Price stability, financial stability, sustainable growth and employment, and a well-functioning payments system matter to all of us. Each of these is important to our collective prosperity. So thank you all for being here tonight.

This is the first of these dinners that I have had the honour of hosting. A particular privilege is to be able to do so in Melbourne, where we had our Board meeting today at our offices on the corner of Exhibition and Collins streets. Four of our nine Board members are based in Melbourne, with Carol Schwartz recently joining Cath Tanna, Kathryn Fagg and Ian Harper on the Reserve Bank Board. It was more than 30 years ago that we last had four residents of Melbourne on this Board and, on that occasion, it was only for a very short period.

At our meeting today, the Board decided to leave the cash rate unchanged at 1.50 per cent. As usual, the reasons for our decision were set out in the statement issued shortly after the meeting.

I don't propose to run through all the issues that were considered by the Board. But there are two issues that I would like to talk about.

The first is the improvement in the global economy. Business and consumer sentiment have lifted in many countries and global trade and industrial production have picked up as well. Commodity prices are also higher than they were for most of last year. Headline inflation rates have returned to near normal levels in many countries, boosted by higher oil prices. And the point of maximum global monetary stimulus looks to have passed. Given all this, at the G20 meetings that the Treasurer and I attended in Baden-Baden in Germany two weeks ago, the tone was much more positive than it had been at previous meetings. Encouragingly, over recent months forecasts for global growth have been revised up, not down as has been the case for the past four years.

So this is a better position than we found ourselves in this time last year.

There are, of course, still some clouds on the horizon. One that dominated discussion at the G20 meetings was a possible retreat from an open rules-based international trading system. If this were to occur it would, clearly, be bad for Australia and the world economy. The positive aspect, though, of these discussions is that they have generated a renewed focus in some countries, including in most emerging market economies, on the importance of the open international trading system. We have a lot riding on this being the outcome.

The improvement in the global environment is helping us here in Australia. Commodity prices are up and there has been some improvement in business sentiment as well. And investment outside the resources sector looks to be gradually lifting after being weak for many years. So this is positive news. Labour market conditions, though, remain pretty soft. Growth in employment is slow and wage growth is the lowest in some decades. We will want to see an improvement here before we can be confident that growth in the overall economy is strengthening. We will also need to assess the effects on the economy from the damage and disruption from Cyclone Debbie in Queensland and the floods in northern New South Wales. It is still too early though for a full assessment to be made.

The second issue that I would like to talk about is the level of household debt and the housing market.

This is something we have been focused on for some time. The level of household debt in Australia is high and it is rising. Over the past year the value of housing-related debt outstanding increased by 6½ per cent. This compares with growth of around 3 per cent in aggregate household income. The result has been a further rise in the ratio of household debt to income, from an already high level.

In aggregate, households are coping reasonably well with the higher debt levels. Arrears rates remain low and many households have built up sizeable buffers in mortgage offset accounts. At the same time, though, slow growth in wages is making it harder for some households to pay down their debt. For many people, the high debt levels and low wage growth are a sobering combination.

In the housing market, conditions continue to vary considerably across the country. The Melbourne and Sydney markets are very strong and prices are increasing briskly. In contrast, conditions are more subdued in most other cities and, in some areas, most notably Perth, prices have declined. Nationally, growth in rents is the lowest for some decades.

So it's a complex picture and there is not a single story that applies across the country. But, as is often the case in economics, it largely comes down to supply and demand. On the demand side, population growth in Australia – especially in our largest cities – picked up unexpectedly in the mid 2000s and it is only in the past couple of years that the rate of home building has responded. This imbalance was compounded by insufficient investment in the transport infrastructure needed to support our growing population. Nothing increases the supply of well-located land like good transport links. Underinvestment in this area is one of the factors that has pushed housing prices up. Put simply, the supply side simply did not keep pace with the stronger demand side. The result has been higher prices.

Not surprisingly, the rising prices have encouraged people to buy residential property as an investment in the hope of ongoing capital gains. With global interest rates so low, many investors have found it attractive to borrow money to invest in appreciating residential property. This has reinforced the upward pressure on prices.

This configuration of ongoing increases in indebtedness and rising housing prices has been discussed at length by the Council of Financial Regulators. This council, which I chair, brings together the heads of the RBA, APRA, ASIC and the Australian Treasury. The concern has not been that these developments have posed a risk to the stability of our financial system. Our banks are resilient and they are soundly capitalised. Instead, the concern has been that the longer the recent trends continued, the greater the risk to the future health of the Australian economy. Stretched balance sheets make for more volatility when things turn down.

Given this, over the past couple of years there has been a concerted effort by APRA to encourage lenders to strengthen their lending standards. This followed deterioration in these standards a few years ago. Also, at the end of 2014, when growth in investor lending was accelerating, APRA announced that it would pay very close attention to lenders whose investor loan portfolios were growing faster than 10 per cent. It did so with the full support of the RBA. This guidance helped pull the whole system back and has made a positive contribution to overall financial stability. So too has ASIC's focus on responsible lending. These measures constrained some higher-risk lending and reinforced the message to lenders that they need to take a systemwide focus in their risk assessments.

Notwithstanding this, given recent trends and the heightened risk environment, APRA announced some further measures last Friday. Again, it did this with the full support of the Council of Financial Regulators.

There are two parts of APRA's announcements that I would like to draw your attention to.

The first is the need for lenders to have a very strong focus on serviceability assessments. Despite the focus on this area over recent times, too many loans are still made where the borrower has the skinniest of income buffers after interest payments. In some cases, lenders are assuming that people can live more frugally than in practice they can, leaving little buffer if things go wrong. So APRA quite rightly has said that lenders can expect a strong supervisory focus on loans with a very low net income surplus.

The second area is interest-only lending. Over the past year, close to 40 per cent of the housing loans made in Australia have not required the scheduled repayment of even one dollar of principal at least in the first years of the life of the loan; only interest payments are required. This is unusual by international standards. In some countries, repayment of at least some principal is required on all housing loans for the entire life of the loan. In other countries, interest-only loans are available only if the borrower has already contributed a fair degree of equity. So this is one area where Australia stands out. We are not unique in this area, but we are unusual.

There are a couple of factors that help explain the popularity of interest-only loans in Australia. One is the flexible nature of Australian mortgages. Many people with interest-only loans make significant payments into offset accounts rather than explicitly paying down principal. This flexibility, which is of value to many people, isn't available in most countries. A second factor is the taxation arrangements that apply to investment in residential property in Australia.

Last week APRA stated that it expected that new interest-only loans should account for no more than 30 per cent of the flow of new loans. It also stated that institutions should place strict limits on interest-only loans with high loan-to-valuation ratios.

Like the earlier 'speed limits' on investor lending, these new requirements should help the whole system pull back to a more sustainable position. A reduced reliance on interest-only loans in Australia would be a positive development and would help improve our resilience. With interest rates so low, now is a good time for us to move in this direction. Hopefully, the changes might encourage a few more people to think about the merit of taking out very large interest-only loans when interest rates are near historical lows.

So the RBA welcomes these latest changes.

It is important, though, that we are all realistic about what these and other prudential measures can achieve. As I said before, the underlying driver in our housing market is the balance between supply and demand. The availability of credit is undoubtedly a factor that can amplify demand, but it is not the root cause. This assessment is consistent with the observation that housing market dynamics currently differ significantly across the country, despite Australia having nationwide financial institutions and the level of interest rates being the same across the country. It is hard to escape the conclusion that we need to address the supply side if we are to avoid ever-rising housing costs relative to our incomes and to avoid the attendant incentive to borrow that is created by rising housing prices.

The various prudential measures do not address the underlying supply-demand issues. But they can reduce the risk from the financial side of the housing market while the underlying issues are addressed. These prudential measures help lessen the amplification of the cycle we get from borrowing and reduce the risk of developments on the financial side weakening the resilience that our economy has exhibited for many years. Ideally, this would be achieved by financial institutions acting themselves, without the need for prudential guidance. But sometimes prudential guidance can help the whole system adjust.

The calibration of this guidance is not precise or straightforward so we need to keep matters under review. The Council of Financial Regulators will continue to assess how the system responds to the various measures so far. It would consider further measures if needed. As I have said, though, in the end addressing the supply side of the housing market is likely to prove a more durable way of dealing with the concerns that people have about debt and housing prices than detailed supervisory guidance.

So that is enough on debt and housing.

Before finishing, I would like to recognise that tomorrow we are having the official opening of our new banknote distribution centre and vault at Craigieburn, in outer Melbourne. This new centre is an important investment for us in Victoria. It will help us manage the task of issuing and storing banknotes nationally for many years to come. The new facility is built around a very large vault and as you can imagine, it is highly secure. It also uses the latest technology and is our first major investment in banknote storage and distribution for decades.

As I hope you are aware, we are currently in the process of upgrading our banknotes to stay ahead of counterfeiters. Counterfeiting rates in Australia remain pretty low but they are creeping up. The new $5 note came out in September last year and the public reaction has been favourable. We are proud of these new notes, not just of the design but also of the high-tech security features. The new $10 will be issued from September and the $50 next year.

As you can imagine, issuing a new series of banknotes is a huge logistical exercise. There are currently 1.5 billion individual banknotes on issue. That averages 62 per person in Australia. We also hold large contingency stocks, which we needed during the financial crisis when the demand for banknotes surged. It might come as a surprise to you to learn that, despite all the talk of a cashless society and electronic payments, the value of banknotes on issue in Australia, relative to GDP, is the highest that it has been in 50 years. Australians have come to rely on our secure and high-quality banknotes. Our new state of the art facility at Craigieburn will help us manage the storage and distribution of these notes.

Thank you and enjoy your dinner and conversation.