

Overview

The outlook for the global economy has improved over the past six months, though some longstanding vulnerabilities remain and some new risks have emerged as others have receded. Longer-term interest rates and equity markets have moved higher as optimism about growth and corporate earnings has risen, particularly in the United States. Nevertheless, after the extended period of low global interest rates, there is a risk that future portfolio adjustments could prove disruptive. In particular, the prices of riskier assets could fall sharply if the 'search for yield' behaviour seen since the global financial crisis reverses quickly.

Risks related to some international political developments have increased, though markets have generally reacted to events in an orderly manner so far. While still under discussion, some of the new US administration's policies, particularly in relation to trade and financial regulation, could adversely affect global economic growth and financial stability. In addition, a number of elections are due to be held in Europe during 2017 that could increase the influence of eurosceptic parties, potentially undermining the resilience of European banks and sovereign debt markets.

Financial stability risks in China remain elevated. The level of debt in China has risen significantly over the past decade to reach very high levels, with particularly strong growth in lending from the less regulated and more opaque parts of China's financial system. Income growth in the more indebted sectors of the Chinese economy has slowed in recent years, making this debt

more difficult to service. In other emerging economies, risks associated with the run-up in corporate debt have receded somewhat, reflecting the rise in commodity prices and the improved outlook for global growth.

In Australia, vulnerabilities related to household debt and the housing market more generally have increased, though the nature of the risks differs across the country. Household indebtedness has continued to rise and some riskier types of borrowing, such as interest-only lending, remain prevalent. Investor activity and housing price growth have picked up strongly in Sydney and Melbourne. A large pipeline of new supply is weighing on apartment prices and rents in Brisbane, while housing market conditions remain weak in Perth. Nonetheless, indicators of household financial stress currently remain contained and low interest rates are supporting households' ability to service their debt and build repayment buffers.

The Council of Financial Regulators (CFR) has been monitoring and evaluating the risks to household balance sheets, focusing in particular on interest-only and high loan-to-valuation lending, investor credit growth and lending standards. In an environment of heightened risks, the Australian Prudential Regulation Authority (APRA) has recently taken additional supervisory measures to reinforce sound residential mortgage lending practices. The Australian Securities and Investments Commission has also announced further steps to ensure that interest-only loans are appropriate for borrowers' circumstances and that remediation can be

provided to borrowers who suffer financial distress as a consequence of past poor lending practices. The CFR will continue to monitor developments carefully and consider further measures if necessary.

Conditions in non-residential commercial property markets have continued to strengthen in Melbourne and Sydney, while in Brisbane and Perth high vacancy rates and declining rents remain a challenge. Vulnerabilities in other non-financial businesses generally appear low. Listed corporations' profits are in line with their average of recent years and indicators of stress among businesses are well contained, with the exception of regions with large exposures to the mining sector. For many mining businesses conditions have improved as higher commodity prices have contributed to increased earnings, though the outlook for commodity prices remains uncertain.

Australian banks remain well placed to manage these various challenges. Profitability has moderated in recent years but remains high by international standards and asset performance is strong. Australian banks have continued to reduce exposures to low-return assets and are building more resilient liquidity structures, partly in response to regulatory requirements. Capital

ratios have risen substantially in recent years and are expected to increase further once APRA finalises its framework to ensure that banks are 'unquestionably strong.'

Risks within the non-bank financial sector are manageable. At this stage, the shadow banking sector poses only limited risk to financial stability due to its small share of the financial system and minimal linkages with the regulated sector, though the regulators are monitoring this sector carefully. Similarly, financial stability risks stemming from the superannuation sector remain low. While the insurance sector continues to face a range of challenges, profitability has increased of late and the sector remains well capitalised.

International regulatory efforts have continued to focus on core post-crisis reforms, such as addressing 'too big to fail', as well as new areas, such as the asset management industry and financial technology. While the goal of completing the Basel III reforms by end 2016 was not met, discussions are ongoing to try to finalise an agreement soon. Domestically, APRA is continuing its focus on the risk culture in prudentially regulated institutions and will review compensation policies and practices to ensure these are prudent. ✎