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RBA warning of 'meltdown'

David Uren, Economics correspondent
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FURTHER rises in oil prices, the collapse of a major bank or an unexpected jump in inflation could be all it takes to send the increasingly fragile global financial system into meltdown.

The Reserve Bank of Australia warned yesterday that the current calm in financial markets could be the prelude to a storm that could wreak havoc in the world economy.

The RBA believes the boom in markets for shares, bonds and housing in many countries is unsustainable.

The warning came as share prices in Australia reached a new high point, while a rush to invest in Australian bonds is pushing down long-term interest rates.

"The preconditions are in place for quite abrupt swings in sentiment and a disruptive snap-back in pricing," the central bank says in its latest review of the health of the financial system.

The Australian share market soared yesterday, with the benchmark All Ordinaries index rising 51.3 points to a record 4565.3.

The share market has risen by more than 12.5per cent in the past four months.

And the RBA says a key measure of all the world's share markets is now 62per cent higher than its 2003 nadir, with the biggest gains made in the riskiest markets. The bank says that financial markets have been acting on a belief that there will be no sharp changes in interest rates around the world. This has resulted in huge investments in government bonds.

In Australia, the long-term interest rate, which is set by the 10-year government bond rate, has been below the cash rate set by the RBA since March.

The belief that rates will remain stable has made investors more willing to borrow to buy shares and bonds.

And with long-term interest rates at historically low levels, investors in international financial markets -- such as insurance companies, banks and superannuation funds -- have been seeking out riskier assets that pay higher returns.

The trend for people to borrow more heavily than before has extended to housing markets, which are still booming in many countries around the world.

"The concern is that the increase in prices and leverage across a range of asset markets might be sowing the seeds for future problems," the RBA says.

"In many markets, there seems to be considerably more scope for asset prices to fall than to increase."

The Reserve Bank says the sooner the correction occurs, the better, as the magnitude of the shock is likely to increase if the boom continues for a few more years.

It says world markets could be sent plunging by a general reassessment of risk in world financial markets.

The possible triggers for such a reassessment include a further increase in oil prices, which hit a record above $US70 a barrel this month, the default of a big borrower such as a bank, or an unexpected rise in inflation.

The RBA believes the risks of Australia's housing downturn triggering a recession have receded, although it warns that the risks have not entirely disappeared.

"The high levels of household debt make the household sector vulnerable to a change in the generally favourable economic and financial climate," the bank says.

Although housing prices levelled out over the past year, it says, home owners are still increasing their debts.

Household interest payments are now equivalent to a record 9.8per cent of household disposable income.

"Those with the highest debt-servicing burdens, or the smallest buffers on which to fall back in adverse circumstances, are often those that have taken out loans only recently, as well as lower-income households and investors," the bank says.