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Debt bomb puts nation in danger

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Soaring debts in a handful of countries including Australia and Canada are putting the global economy at risk of recession, according to the peak global central banking authority, the Bank for International Settlements.

In a stark warning delivered as Australia's political system fails to generate meaningful economic reform, the BIS says Australia is one of the countries most at risk from a rise in interest rates, which would push up the cost of servicing mortgage debt to a level that would force a slump in household consumption.

“The main cause of the next recession will perhaps resemble more closely that of the latest one — a financial cycle bust,” the BIS, known as the central bank to the central banks, says in its annual report, released last night.

“The classical signs of financial cycle risks are apparent in several countries largely spared by the global financial crisis, which saw financial expansions gather pace in its aftermath.”

The biggest threat to the world economy is identified as China but, in another warning relevant to Australia, the BIS says the risks also extend to “commodity exporters buoyed by the long post-crisis commodity boom”.

The sobering assessment follows repeated warnings from Reserve Bank governor Philip Lowe that the elevated level of household debt is making Australia more vulnerable to an economic downturn. The RBA recently revealed a third of mortgage holders do not have a buffer against income loss, and are less than one month ahead on their payments.

Private sector surveys have shown that almost a quarter of households face “mortgage stress”, meaning other consumption is crimped to make way for mortgage payments.

The likelihood of interest rate rises in the US could also filter through to Australia's economy.

In an interview with *The Australian*, Stanford economist John Taylor, considered a potential replacement for Federal Reserve chairwoman Janet Yellen, urged the Fed to press on with rate hikes even if inflation stays low, warning the RBA of the dangers of keeping interest rates too low for too long.

The BIS says the global economy is in its best state since the global financial crisis as growth extends to virtually all major economies while unemployment levels fall.

However, the bank warns that if interest rates rose by 2.5 per cent, as they did between 2002 and 2007, the debt service ratio could soar by 5.2 percentage points. It says this sort of increase is typical of financial crises.

As well as the 2008 crisis, the BIS says the recessions around the world in the early 1990s were also preceded by “outsize increases in credit and property prices, which collapsed once monetary policy started to tighten, leading to financial and banking strains”.

The BIS says the proportion of household income consumed by servicing debt is a key indicator of financial risks.

Reserve Bank figures show Australian households are spending an average of 8.5 per cent of their quarterly disposable income on interest payments, down from a 2011 peak of 11.5 per cent. Canada is the only advanced country which would be more severely affected by such a rate rise, with debt-service ratio's rising by 7.6 percentage points. However, China, where households are already paying much more of their income on interest than usual, is even more exposed. Other advanced economies with rising household debts are Switzerland and Sweden.

The BIS says "rapid household credit growth has featured prominently in financial cycle booms and busts". Household debt outpacing GDP growth over prolonged periods is seen as "a robust early warning indicator of financial stress".

Australia's household debt has been rising faster than GDP since 2012, lifting from 110 per cent of GDP to 123 per cent in the latest quarter.

The BIS says that even if it the house borrowing boom does not result in "financial distress", it could still weaken future economic growth.

The BIS cites research showing that a one percentage point increase in the ratio of household debt to GDP is associated with a fall in the long-term growth rate of 0.1 per cent.

The BIS says central banks in countries with elevated debts need to adopted a gradual approach to returning interest rates to more normal levels, but it also said there was a "risk of waiting too long to normalise" because greater accumulation of debts would be encouraged.

In their post-budget reviews of the Australian economy, the major credit rating agencies all referred to the elevated level of household indebtedness.

S&P Global commented that for Australia to secure its AAA credit rating, there would have to be a "meaningful moderation" of the credit and house price boom.