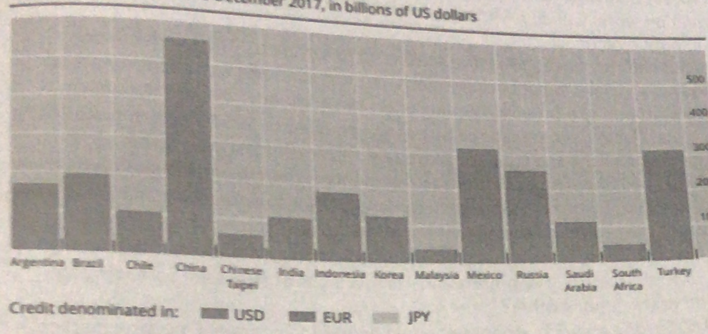
Governments are running low on monetary and fiscal ammunition needed to fight fresh shocks or to cope with recession. An inflation surprise may lurk, risking a "snapback" in global bond yields and a horrid denouement for an investment universe built on assumptions of "lowflation" forever. The rising US dollar threatens to set off a sudden liquidity squeeze and a rash of capital flight from emerging markets, now 60 per cent of the global economy and big enough to engulf the old world if unfolding events are mishandled.

Foreign currency credit to EMEs

Amounts outstanding at end-December 2017, in billions of US dollars



Source: BIS global liquidity indicators (Table E.2).

Global debt has risen from 179 per cent of GDP on the eve of the Lehman crisis to 217 per cent as emerging markets are sucked into the leverage sump.

Banks have higher capital ratios and are safer than in 2007 but the risk has rotated to pension funds, insurers and asset managers overseeing $US160 trillion of global wealth - including $US45 trillion of shadow banking - now clustered in "crowded trades" with narrow exits. Any one of these scenarios could trigger a crisis. They might well combine. Global debt has risen from 179 per cent of GDP on the eve of the Lehman crisis to 217 per cent as emerging markets are sucked into the leverage sump.

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The emerging market debt ratio as a whole has jumped by 63 percentage points in a decade. There are already signs that the financial cycle is turning in several of these countries, including China. A long hangover awaits.

"The higher the debt, the more sensitive the economy and financial valuations are to higher interest rates," said the report. Public debt has reached post-war highs in both rich and emerging economies. Fiscal profiles have been "flattered" by financial expansions and the windfall of fair-weather tax revenues. It is a Faustian pact.

Promiscuous recourse to debt brings forward prosperity from the future, but eventually the future arrives - with a sting in the tail: the extra debt leads to "deeper and prolonged recessions". "There is a limit to stimulating activity with debt," said Hyun-Song Shin, the bank's head of research. The BIS says governments have to walk a treacherous and narrow path in these circumstances, careful not to kill the recovery by over-tightening or to let the inflation genie out of the bottle by running economies too hot. An error either way will be severely -punished.

The imperative is to build up "fiscal space" while the going is good. The Trump administration is doing the exact opposite with a fiscal spree that pushes the budget deficit towards 5 per cent of GDP at the top of the economic cycle when the output is already closed. The deficit should be nearer zero.