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Rising credit and fear of the bubble

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House prices are rising, heralding the arrival of another credit boom.

A familiar story of bubble, not from USA

This time, it is from China.

China's domestic credit to private sector is rising. From 125 per cent of gross domestic product (GDP) in 2008, it rose to 215 percent in 2012. It is 230 percent now.

Last week, we discussed inflation in emerging economies, including Argentina, and depreciating currencies.

Rising property prices in China

This week, Ruchir Sharma of Morgan Stanley Investment Management warns: "Forget Argentina: We have the black cloud of debt hanging over China".

A former central banker, Datuk Seri Andrew Sheng now heading the Hong Kong based Fung Global Institute, has also voiced his concerns about China's financial sector.

China is having rapid credit growth at very low interest rates. For past ten years, the one-year fixed term deposit rate in China was two to four per cent, roughly equal to the consumer inflation rate. The lending rate for loans for urban mortgage borrowers has also remained relatively stable, at five to seven percent.

“The combination of easy credit, low official rates and high demand caused property prices to surge by 300 to 500 per cent in some Chinese cities over the last decade”, Sheng’s study notes.

Besides formal bank channels, shadow banking channels have also emerged and are thriving.

Low official deposit rates and low lending rates have been exploited by the privileged. New entrants to labour market go to shadow-banking channels, where rates are as high as 20 percent. The estimates reveal an increase of 43 percent in shadow-banking credit in 2013, accounting for 29 per cent of China's total credit.

Will this credit boom last?

Ruchir Sharma of Morgan Stanley says “No”.

A credit boom is defined as rise in growth in two successive periods, in which the ratio of nominal private credit to nominal GDP deviates from trend by a certain threshold. This threshold varies from 2 to 10 percentage points of GDP. This variation is called credit gap.

Over the past 50 years, 33 countries had a credit gap of 42 percentage points. About 22 of them had to face a credit crisis in the subsequent five years. They include Thailand, Malaysia, Chile, Zimbabwe and Latvia. Their credit gap was above 60 percentage points.

Their economic growth rate fell from 5.2 per cent to 1.8 percent.

Sharma estimates China’s credit gap is increasing. It is up by 71 percentage points in 2013, from 2008.

The fears of economic doom from the credit boom are real.

How about London?

BBC report says London too is facing rise in house prices.

A study by Ernst and Young puts the blame on a high percentage of overseas buyers, who bring in their savings seeking good investments.

According to UK think tank, Civitas, the locals are being priced out of the market with soaring house rents. Calling for curbs on overseas buyers of London property, Civitas argues non-residents of the UK should only be allowed to purchase a property in London if that investment will add to the number of homes, under a system similar to the one in Australia.

The message is clear: house buying should not be a speculative activity, just as buying a share for selling tomorrow for capital gains.

Fiji situation

The latest rising trend in Fiji's domestic credit to private sector is welcome. It reflects growing confidence about the future. The Reserve Bank of Fiji's latest review reveals that total domestic credit has been increasing at around 13 percent each month in last three months, compared to a year ago.

In November 2012, it was just 2 percent.

However, bank loans for real estate were rapidly rising.

In 2012, the outstanding credit was F$372 million compared to F$ 351 million in 2011 and F$317 million in 2010. Monthly data for 2013 show credit for real estate has been rising: F$381 million in March, F$393 million in June and F$413 million in September.

There are disconcerting developments.

Properties, including vacant land and existing houses, whose sales were executed just a few months ago are again put up for sale by realtors.

The latter are fuelling speculation.

If there is a fall in stock prices, the speculators have a favourite term: the falling prices are nothing but self-corrections in an unsustainable market.

After comforting themselves, they would resume the next round of speculation.

Monetary authorities cannot afford to take any comfort in the term.
Market self correction may prove self-destruction.