Where did the comgrades go wrong

Recently, we were reading some new analyses by BIS. No, we're not referring here to the former Czechoslovakia's secret police which went by the same initials (Bezpečnostní informační služba) but to the Bank for International Settlements. This is a highly respectable international organisation supporting international monetary and financial co-operation and which serves as a bank for central banks. Its analyses are excellent and well worth reading.

In this particular text, BIS says that the key indicator for recognising a credit bubble is an unsustainable rate of growth in households' and non-financial corporations' borrowings relative to GDP. This makes intuitive sense, and a look into history shows that Japan in the early 1990s, Thailand in 1997, the US in 2007, and Spain a bit later were all cases of just such credit bubbles. Credit crises followed the bursting of the bubbles, as did large write-offs of bad loans, recessions, as well as substantial drop in equities and real estate prices, and, with the exception of the US, in the local currencies.

We immediately got the idea to take a look whether any countries in the world today are in a similar situation. We found three of them: Canada, Australia, and China. This came to us as no great surprise, because all of these countries have been discussed in this respect for some time. Nor is it altogether coincidental that it is these countries in particular, because their credit expansions are in fact related. China's effort to grow at any cost causes a large need for investments. Canada and Australia are profiting from this by exporting their commodities to China and, in addition, China is massively investing back – primarily into Canadian and Australian real estate. China is the driving force behind all three credit bubbles and will apparently be the first place where the bubble bursts.

China is trying to maintain its high GDP growth rate at any cost. The only way to achieve this is through massive investments into fixed assets and infrastructure. China has an exceptionally high ratio of investments to GDP. Unfortunately, a large part of these investments are entirely unproductive and bring no value. Most of these investments are financed by loans, of course, and here lies the crux of the problem. In order to maintain the high rate of growth, the volume of new loans must be always increasing. Of course, a large portion of those are bad loans.

Sooner or later, therefore, China can expect its so-called Minsky moment. That is the point at which such a trend reverses itself. The volume of loans necessary for financing further growth will be so large that there will be no possibility to satisfy that demand. Growth will cease, liquidity will run dry, markets will freeze, and everyone will try to salvage what they can. Also important is how big the problem of bad loans will be. In China, unfortunately, it is gigantic. The volume of households' and non-financial corporations' borrowings relative to GDP is approximately 220%. This ratio was 160% in the US back in 2007, and we remember well how turbulent that was. The estimates of bad debt in China vary, but Charlene Chu, for example, one of the most respected China analysts, states that it is USD 7 trillion. That is approximately 70% of China's GDP.

This is due to the combination of a high proportion of bad loans and the incredible swelling of assets in the Chinese banking sector. For the sake of comparison with our small Czech conditions, this would mean that Czech banks would have bad debt in the amount of CZK 3.3 trillion. We can scarcely imagine such a thing. China is going to have to deal with this. What could this look like?

Massive write-offs of bad debt will require an immense bank recapitalization, which can only come from the government. The state will have to compensate for the credit insufficiency in the private sector with a massive expansion of the money supply. Our old friend QE. But this time with a really big Q! The currency will have to be devalued, by an estimated 25%. Bank stocks will become worthless, equity indices will endure a sharp correction, because they are expensive today and because banks have a large representation within the indices. Real estate prices will be in a depression and the economy in recession. Many Chinese businesspeople and investors essentially expect this somehow, and therefore we have been witnessing massive investments outside of China for some time. Money must continue to flow outward for as long as it can and for as long the yuan exchange rates are still high.

How long will it be until that moment comes? In all those cases cited above, it came shortly after the curve showing the ratio of households' and non-financial corporations' borrowings to gross domestic product turned downward. In Canada and Australia, that happened this year. In China so far, it has continued successfully to press upward. So, we still have time to think of how to profit from the situation when the turn comes.

Invest with care!

Daniel Gladiš, published in Fondshop, October 2017

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