US and UK warned against an ‘illusory’ credit bubble

By Philip Coggan, Investment Editor

A new report, commissioned by the leading hedge fund group Odey Asset Management, argues that the growth of US and UK credit in recent years has led to an “illusory prosperity” that will end either in a period of extraordinary deflation or extraordinary inflation.

The report, written by journalist Edward Chancellor, argues that monetary authorities, in attempting to stave off the deflationary effects of the collapse of the dot-com bubble, have created another bubble in housing and consumer credit.

Furthermore, the US Federal Reserve’s repeated willingness to cut interest rates has created a moral hazard in the system. Financial institutions have responded by increasing their leverage, the amount of debt taken on relative to their capital.

In addition, artificially low short-term interest rates have encouraged the “carry trade”, with investors borrowing short-term and lending long-term.

Loose credit policy has not shown up in consumer price inflation, but in asset price rises, with too much money chasing too few assets. Investors have suffered from “money illusion”; they may have failed to consider that lower inflation also implies lower future growth in profits and income.

Eventually, this credit bubble will pop, the report argues. “Asset bubbles require ever-increasing amounts of credit in order to remain inflated. When credit ceases to grow, they deflate.”

This may either lead to deflation, as debts default, and asset markets suffer from a lack of buyers or from rapid inflation, as monetary authorities deplete the currency to reduce the burden of debt repayment.

Crunch time for credit: An inquiry into the state of the credit system in the US and Great Britain, to be published by Investor Publishing on February 4.