What exactly is the Credit Crunch?

1. Financial institutions such as banks and building societies cut the amount that they are prepared to lend to each other – this is known as a **decline in inter-bank lending** in the wholesale money markets.

2. The fall in the supply of credit leads to a **rise in inter-bank interest rates** e.g. in the UK we have seen the LIBOR rate move well above the UK bank base rate set by the Monetary Policy Committee.

3. This increase in wholesale interest rates feeds through to **higher interest rates** for mortgages and credit cards - making borrowing more expensive for ordinary people and for homeowners.

4. It can also make it more difficult for businesses to raise fresh capital through bond issues – forcing many of them to look to the stock markets for streams of new capital e.g. by making use of rights issues.

5. The crunch involves a **draining of liquidity** in the financial system – driven by worries among investor about where the bad debts are (e.g. bad loans linked to the sub-prime market).

**Macroeconomic Consequences of the Credit Crunch**

**US Housing Market**
- Fall out from sub-prime crisis – inc rising mortgage defaults and collapse of mortgage lending
- Bad debts causing write offs and big losses for many banks / hedge funds
- Fall in housing demand and sharp decline in construction output and jobs
- Fall in property prices - negative wealth effect for US economy e.g. falling consumption

**Financial markets**
- Equities
  - Boost for commodity-related equities e.g. mining companies
  - Downside for banking stocks / internet stocks and other financial businesses
  - Shift towards internal funding by corporations - less borrowing
  - Increasing role for sovereign wealth funds - providing source of fresh finance / capital
  - Insurance - worsening of credit ratings for insurance companies linked to the sub-prime

**Household sector**
- Harder to get loans
- Increased mortgage interest rates (hits people’s effective disposable income)
- Increased incentive to save (e.g. for a deposit)
- Negative wealth / confidence effect from falling property prices

**Other consequences**
- Rise in inflation due to soaring commodity prices – linked partly to the decline of the US dollar
- Worries over stability of banks / savings
- Fall in employment in construction and related industries
- Downturn hits other parts of the real economy including autos because of negative multiplier effects

1. Bail outs - (e.g. Northern Rock (nationalized) and Bear Stearns (sold at rock bottom price))
2. Fed Reserve has slashed interest rates in the states (now 2%) + Bush’s $150bn tax cut (fiscal stimulus)
3. Most central banks have provided emergency lines of finance for the financial system