Examine the likely econom ic effects of the credit crunch

Before one can truly examine the economic effects of the credit crunch it is important that we understand what we mean by the credit crunch. The credit crunch itself is a by product of what has become more commonly known as the debacle in the "sub prime loan market." The sub prime loan market is a market in which lenders have lent large sums of money to borrowers who may have had difficulty in servicing the debt. The main protagonist in this drama that is unfolding is the USA. US banks who wanted to get these debts of their balance sheet to allow for other more profitable loans repackaged these debts and sold them on the international debt market a process known as "securitisation." Many UK and other banks purchased these sub prime loans and are no paying the heavy price of doing so. The borrowers in the US are now defaulting on these debts and therefore the liquidity that banks thought that was coming their way has dried up. Northern rock was the first UK bank that did not have sufficient liquidity to meet the demands of its depositors and was refused money on the inter bank market for fear that it would be unable to repay the debt. Moreover, banks lend to each other and take security from the borrowing bank by way of book debts. However, lending banks were fearful that the book debts of borrowing banks may be made up of sub prime loans. Consequently, banks refused to lend to one another thereby drying up the funds available to consumers and companies. In the most recent twist in the tale the government have allowed banks to swap their debts for government bonds which lending banks can take as security over. This will create confidence in the banking sector and should open the flood gates of lending. The Bank of England has also promised to inject £50bn in to the banking sector to ease the lending woes. The restriction on lending between banks is what has become known as the "credit crunch."

Having set out what the credit crunch is and where it emanated from the discussion can now move on to consider the economics effects of the credit crunch. The restriction on lending will lead to less loans being available to consumers thereby causing a fall in consumption. Consumption as we know is a component of AD so this will cause a left ward shift in AD from AD to AD1. There will therefore be a fall in GDP and hence actual economic growth. The resulting fall in GDP will mean the output will decrease which may cause firms to lay of workers and hence unemployment will increase. However, this may not be a concern if the UK has a sufficiently flexible labour market with little occupational and geographical immobility of labour. In addition, the restriction on lending will mean that companies are less likely to take out loans. The problem is magnified as restrictions on money being available for lending will push up interest rates as the supply for money remains constant, thereby increasing the cost of borrowing. The increase in unemployment will lead to less income tax being paid by consumers and an increase in government spending on unemployment benefits leading to a worsening of the fiscal deficit. This may lead to a deterioration of public services and the government may be forced to borrow to fund current spending. This may lead to the 'crowding out' effect which causes further decreases in private sector investment.

The decrease in actual economic will lead to fall in living standards as people do not have the income to maintain their living standards. Moreover, the inequality gap may widen as the distribution of income becomes more uneven. The economy will begin to move within its PPF curve this creating what is known as an "output gap." However, the fall in actual economic growth will lead to a fall in the depletion of scarce resources and the fall in the price level.

Consumer and business confidence will also be low as economic agents will be uncertain about the economic climate and may suspend spending and investment. In particular, the fall in global share prices caused by the credit crunch will heighten the uncertainty felt by consumers and businesses. Those consumers that owned shares will cut back on planned consumption due to the "negative wealth" effect. However, the decrease in the price level will increase the real value of savings which may lead to economic agents increasing their spending.

The fall in AD will lead to fall in the price level which may increase the competitiveness of UK good in overseas markets. This may improve the trade deficit position. However, this will depend on whether consumers in foreign countries continue to demand overseas products as the credit crunch is global. It will also depend on the elasticity of the goods in question. There may also be a fall in trade in services as the amount of global deals being done slows down. One also needs to take into account the exchange rate. A high exchange rate may nullify any decrease in price as it will make UK exports more expensive in overseas markets.

Despite the negative consequences of the credit crunch the MPC have been cutting interest rates to increase consumption and investment to boost aggregate demand. However, the decrease in interest rates has not been passed on to consumers by banks. As Keyenes once famously said "monetary policy is like pushing on the end of a piece of string." The latest efforts by the government to allow banks to swap their debts for government bonds will add confidence into the market and encourage banks to begin to lend to one another. Hopefully, this may counteract the negative aspects of the credit crunch.