World economy: Credit crunch fallout begins to spread

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While stock markets have stabilised—at least for the time being—the effects of the credit crunch sparked by the crisis in the US subprime mortgage market are now working their way through the banks and financial institutions and the economy as a whole.

This week, the financial fallout spread to Britain where HBOS, the owner of Halifax and Bank of Scotland, announced that it would extend credit to Grampian, a $37 billion debt-financed fund, or conduit, which deals in repackaged loans, including mortgages, credit cards, and motor loans. The bank said the funding would continue until market finance improved to an acceptable level.

In Germany, where two banks IKB and SachsenLB have already been hit by the liquidity crisis, it is clear that the problems extend deep into the financial system. As a report in Monday's *Financial Times* noted: "SachsenLB and IKB may have been small players but the impact of their downfall and the embarrassment faced by the Bundesbank [Germany's central bank] have spread far beyond Germany. Financial markets and policymakers have been left worrying whether further bank crises are lurking and whether bank regulators are really in command of the facts."

According to Alexander Stuhlmann, the chief executive of WestLB, another state-owned regional bank, the situation facing the German banks was "not uncritical." "We sense a reluctance on the part of foreign partners to extend credit to German banks," he said. "If we have a banking crisis in Germany with other countries cutting us off, then other banks will also face difficulties."

The German banking system has been among the hardest hit by the credit crisis because of the moves over recent years by smaller banks, particularly the state-owned Landesbanken, to counteract the effects of a downturn in the domestic market and increased competition pressures by engaging in riskier financial investments. While the major Landesbanken are outside the top 30 of Europe's biggest banks, they all rank among the top 30 conduit sponsors.

The problems in the banking sector have led to calls from industry for the European Central Bank [ECB] to cancel a rise in interest rates planned for next month. According to the German Chamber of Industry and Commerce (DIHK), banks had already tightened lending standards and raised borrowing costs for small companies.

Issuing a plea that the ECB not raise rates, DIHK chief economist Axel Nitschke said: "What we are seeing in the credit markets is likely to have a major effect, damping economic dynamism in coming months, not just in Germany but across the world." He said the DIHK had been receiving distress calls from middle-sized German companies back in June.

The flow-on effects of the crisis on the broader economy were also the subject of a warning by John Lipsky, the number two official at the International Monetary Fund. Speaking to the *Financial Times*, the IMF first deputy managing director warned that the financial market turmoil would "undoubtedly dampen economic growth". While so-called "emerging markets" had so far withstood the crisis, he added, it was "far too optimistic" to assume that there would be no impact at all.

There would be no quick end to the turmoil because of the uncertainty as to how much damage it would do to economic growth. There were also dangers for the entire financial system caused by the lack of transparency on the part of the banks as to the true extent of their exposure to riskier investments.

"Lack of transparency can create doubts that translate

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into market volatility," Lipsky said. "We are finding that in some cases regulated financial institutions are carrying off-balance-sheet risks that have indirect implications for those institutions." This had caused uncertainty about the level of risk borne by major institutions, which contributed to the drying up of liquidity in parts of the financial market.

As far as the broader economy is concern, the chief fear is that the slump in the US housing market will lead to a fall in consumption spending and the onset of a recession. On Thursday, Countrywide Financial's chief executive Angelo Mozilo warned that the housing market was showing no signs of improvement. Asked if this could bring about a recession, he said: "I think so ... I can't believe ... that doesn't have a material effect." There was a "very serious situation" in the US housing market and the environment was "certainly not getting better."

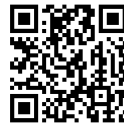
The latest industry figures and surveys bear this out. The median price of new homes has fallen from $262,000 in March to $237,000 in June—a decline of nearly 10 percent in just three months—while the overhang of unsold homes is equivalent to 7.8 months' supply.

According to the data firm RealtyTrac, the number of US homes facing foreclosure increased by 58 percent in the first six months of the year. In all, 573,397 properties faced some kind of foreclosure activity in the first half the year, including notices of default, auction sale notices, or repossession by lenders. And the number of foreclosure filings could rise to 2 million by the end of the year.

The housing slump is impacting on other areas of the economy as profit warnings by Wal-Mart, Home Depot and Macy's indicate. Car sales in July were the lowest in nine years.

Some of the processes at work in the mortgage crisis and in the US economy as a whole were revealed in an article on income figures published in the *New York Times* on Monday. An analysis of tax statistics revealed that the average income in 2005 was still 1 percent less than in 2000 after adjusting for inflation. This was the fifth consecutive year that American wage-earners had made less money than at the peak of the last cycle of economic expansion in 2000. This was a "totally new experience" in the post-war period, which saw total incomes listed on tax returns grow every year, with a single-year exception, until 2001.

These statistics make clear why the housing bubble, which played such a decisive role in the growth of the US economy since the recession of 2000-2001, was destined to collapse. While house prices and consumption spending in general were being inflated by the expansion of credit and lower interest rates, real income for the vast majority of working people in the US was going in the opposite direction, creating the conditions for a "scissors crisis." Now the bursting of the bubble has set in motion economic forces that could bring a recession not only in the US, but in the world economy as a whole.



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