World economy: Credit crunch could bring recession

Nick Beams
7 September 2007

While global share markets appear to have stabilised—at least for time being—it's a different story as far credit markets are concerned. Here there are fears that a growing crisis could spark a major downturn in the world economy.

In an article on Wednesday, the *Financial Times* pointed to problems in the interbank markets, where banks and major financial institutions lend to each other. Here interest rates are on the rise "suggesting a frantic scramble for liquidity among financial groups."

This was "deeply unnerving" for policymakers and investors because it was taking place despite the massive injections of liquidity into financial markets by the US Federal Reserve and the European Central Bank—moves that were aimed at trying to calm money markets and ease the credit crunch.

The report cited one market analyst who stated that the interbank lending business had "broken down almost completely", not only in the euro and dollar markets but across the world.

Concerns about the state of credit markets and the implications of the absence of liquidity were the subject of a statement from the European Central Bank on Wednesday. It warned that financial volatility was returning after a brief period of stability.

The ECB alert came as the Organization for Economic Cooperation and Development (OECD), which embraces the world's major economies, issued a report warning that economic growth, especially in the United States, could be adversely affected by the financial market turmoil.

While the crisis had struck under conditions when world economic momentum was still strong, future prospects were more uncertain. "Downside risks have become more ominous, in a context where overall financial market conditions are likely to remain durably tighter," the report stated.

Economic growth in the United States was likely to fall "distinctly below potential" during the second half of this year following a strong rebound in the second quarter. The report cautioned that its predictions "may err on the upside, since it has not been possible to fully evaluate the negative impact of credit market turbulences on economic activity."

The report's author, OECD chief economist Jean-Philippe Cotis, said a US recession could not be ruled out.

Figures issued on Wednesday showed the extent of the decline in the US housing market. Demand for housing fell to a six-year low as lending conditions tightened. While the expectation had been for a 2 percent drop in home sales, the decline was actually 12.2 percent, according to the National Association of Realtors.

Merrill Lynch chief economist David Rosenberg said: "There is absolutely no question the housing sector is going from bad to worse. Even with the deterioration in home prices, we can see demand continuing to fall."

And the decline is set to continue in the coming months. Figures issued by the Mortgage Bankers Association for the second quarter of the year—that is, before the latest tightening of credit—show that a record number of homes entered the foreclosure process.

In the case of subprime adjustable-rate mortgages, 18 states reported that at least 19 percent of these loans were "delinquent." In Mississippi and West Virginia, the figure was more than 26 percent. Second quarter foreclosures were 44 percent higher than the corresponding period in 2006.

In another report released on Wednesday, the United Nations Conference on Trade and Development said world growth would slow to 3.4 percent this year from

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4 percent last year. It warned of the possibility that an "outright contraction" in American house prices could lead to cutbacks in consumer demand, impacting on exports from developing countries.

An indication of the growing sense of crisis in the credit markets was provided by a report and a letter that appeared in the *Financial Times* this week. On Wednesday, the paper reported remarks by Hans Jörg Rudloff, chairman of Barclays Capital, who said financial markets had suffered a "heart attack" and now faced a critical period of convalescence. The next four to six weeks would be crucial as investors tried to establish price levels for asset-backed debts.

"This is the big question: are we capable to establishing a new price level for these assets? If we stay stuck, the patient is going to die," he told a meeting of Russian business executives in Moscow.

The following day the *Financial Times* published a letter from Paul Mortimer-Lee, the global head of market economics at BNP Paribas, a leading private bank. Expanding on the "heart attack" analogy, he said the situation was serious but the central banks had so far confined their activity to dispensing aspirin when a defibrillator was needed. More serious treatment was being withheld on the grounds of "moral hazard"—the claim that major intervention provided an underpinning to bad investment. This was equivalent to denying treatment to the heart attack victim on the grounds that he should have improved his diet and exercised more.

According to Mortimer-Lee, the liquidity injections organised by central banks had failed and a credit crunch was coming.

"When the patient is in seizure and the extremities are starting to turn blue it is not the time to worry about the patient's longer-term dietary plans or about undesirable side-effects of the current treatment. Yet I fear this is what central banks will do. The next set of steps had better be convincing and decisive, otherwise a much wider financial implosion and economic recession will become very likely."

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