Credit crunch essay

ASSIGN BUSTER

Any large business house, consumer expenditures or governmental schemes may borrow public money in the form of selling shares. It is the function of large financial institutions, such as banks, to issue or generate credit transactions. A smooth inflow of credit between the borrower and the lender is what establishes ideal market conditions. A credit crunch occurs when there occurs a lack of obtainable credit in the market and the borrowers cannot find adequate finance. Usually such a phenomenon happens when the creditors are unwilling to invest more money or hike up their interest rates to such exorbitant levels that it becomes virtually impossible for the lender to borrow.

The central question, then, is why do the creditors suddenly refuse to invest more money? Actually, far from being an isolated fact, it is a part of a complex chain reaction. The lenders reel under deficit money supply when they fail to realize the interest or even the actual capital they had invested on companies or institutions, which accrued a disastrous amount of losses. Such loss incurring companies cannot return the money they had borrowed from the creditors and have to default payment. However, when the prices begin to fall, even the bank has to sell out at considerably lower prices and suffer huge losses.

Consequently, their ability to lend money is severely crippled. In certain cases, the banks are required to raise the level of capital reserves and to comply with this have to restrict lending. Even when banks perceive a risky market, interest rates may shoot up to discourage lending to credit crunch. (Whybrow, 2007)The world has seen such crisis in the past and incorporated

different methods as bailout plans. The 1932-53 crises called for reconstruction of Finance Corporation and the trigger was Great depression.

The 1989-95 crises needed Resolution Trust Corporation and the trigger was savings and loan crisis. Here 747 small companies were affected and the cost was $300 billion where the initial cost estimation was $50 billion. In other countries too, like Sweden (1992-96) and Japan (1996), the resolution was in form of Bank Support Authority in Sweden and Resolution and Collection Corporation in Japan and in both the cases, the trigger was fallout from a real estate bubble. (Wolfson, 2007)For many months after August 2007, the financial market has been loosing, more than making, money. The consumers in USA have been living beyond their earnings. They have been constantly borrowing money to pay for their houses and sustain their everyday requirements.

Most of the asset prices, like the cost of houses, have elevated rapidly, making it a huge burden on first time purchasers. The lenders have been practicing securitization, where they have clustered the poor-quality loans by mixing them with some good-quality mortgages, and selling the whole thing as a package of debt. They have also lessened the criteria for giving a loan. (Elliott, 2008)Five of the leading banks of the world, including the Federal Reserve Bank of USA came together to invest huge amounts of fresh money into the global market to combat international credit crunch failing economy with about one trillion dollars.

(Grynbaum, 2008) This move is largely stimulated by the concern of leading economists who were predicting a recession in US markets as a slowing

down or decline of US and British housing markets. In an emergency set of solution seeking procedures, the Federal Reserve Bank drastically diminished interest rates, splurged out innovative lending programs, sought to modify the poor condition of Bear Stearns and provide loans to boost the nearly crippled mortgage agencies of Fannie Mae and Freddie Mac. However, in the event of magnifying unemployment and inflation, the Federal Bank cannot afford to sit still. It has to fight for a stable equilibrium in prices and combat unemployment. The most innovative plan to diminish the credit crunch has been to increase lending with the motivation tom restore liquidity to troubled markets and look after the demands of the inter-bank loaning facilities. (Cecchetti, 2007) The current crisis made the Federal Bank to decrease the interest rates on lent amounts and lengthen the time limit for the repayment of the loan.

“ Term Auction Facility” was adapted as a scheme for slow banks through which loans at a cheaper rate could be made available from discounts windows and the deals were guaranteed anonymity. (King, 2005)Under such parameters the fundamental bailout plan “ Hank Paulson’s $700 million no-strings-attached proposal” was disapproved by the US House of Representative. (Rankin, 2008) There is however, a second bailout plan. It is referred to as Plan B. The Federal Reserve endorses this plan after the failure of the Plan A. It has been reported, “ tax credits for the production and use of renewable energy sources, like solar energy and wind power have been.

Possible other inclusions originating in the House bill are an extension of the unemployment benefits, protection from foreclosure for individuals, and tax credits for low and medium income households.” (Rankin, 2008) Under such

parameters, it can be stated that the this plan was initially supposed to be workable but a Plan C was initiated to be effected as a proper bailout method. Plan C includes an additional input of US$800 billion by the Federal Reserve. The amount of US$800 billion would be instrumental in buying the debts related to mortgage and the credits of the consumers in order to instrument a lending free up.

At this point of time it appears that there are two major problems related to this Plan C. The first one is the fact that there is not enough retail economy spending in relation to consumers. Secondly, there is a lack of consumer credit and there is no presence of a sound economy to sustain this amount. It is reported that “ the Federal Reserve and US Treasury are pumping a jaw-dropping $800 billion directly into the credit markets, buying up $600 billion worth of mortgage debts”.

(3news, 2008) The net probable result is that “ agencies like Freddie Mac and Fannie Mae can keep mortgage credit flowing, and setting up a new $200 billion loan fund to buy up consumer credit and prop up the market for auto loans, student loans and credit cards.” (3news, 2008)Under such parameters, if the plan B is taken into consideration, it can be stated that this plan appears to be a very slow process. This could be a very dangerous ploy and the result could be devastating for the economy. It should be noted that a very fast and effective measure is needed and Plan B lacks that speed of operations that is required in this case. As per implecation of Plan B is concerned it can be mentioned, “ Pressure is also mounting from constituents for Congress to take action to stop the extreme volatility in the markets as their investments have plummeted.

While stiff opposition to a bailout of Wall Street is apparent, direct damage to the net worth of individuals has prompted a call for action” (Rankin, 2008) Thus, it appears that Plan B is not workable at all. On the other hand, Plan C has its own faults. Henry Paulson, Treasury secretary, indicates, “ This lack of affordable consumer credit undermines consumer spending and as a result weakens our economy”. (3news, 2008)Thus, it is difficult to implement this plan on a large scale. The market appears frozen and the credit system is crippled as investors pulled out $240 billion out of the market particularly from the field of auto loans and credit card market. The Federal Reserve bailout plan of $180 billion could be instrumental in luring investors into the market.

In a way, this could prove to be the ideal stage to implement Plan C though there is enough risk involved. Nevertheless, Plan C is quite complicated in nature and it the Federal Reserve is reluctant to use it right now and hold it until February 2009. (3news, 2008)However, serious situation demands serious risks. As it is, it looks like the Plan B would not be effectively instrumental without a long termed result and this is a situation that needs quick response.

Thus, the best measure is to wait until February 2009 and implement the Plan C. During this time, the drawbacks of the plan would be well sorted out and thus the implementation would be more error free and sustainable. That way, it would be faster and effective than Plan B. Thus, Plan C is the most favorable plan under these circumstances, the government should be instrumental in implementing this plan, and the entire world with its multicultural help should assist and back this move. The decade leading up

to the stock market crash of 1929 and the following Great Depression is typically remembered as one of great prosperity; everybody, it seemed, was getting wealthier. While the rich added to their riches, even the working class was beginning to earn a little bit of money to put away.

The middle class was inching closer to luxury with the money it had made in investment markets. All signs were pointing up. It was precisely this shared spirit of unbridled optimism, however, that led to the crash and the subsequent depression; the Thirties were particularly horrific specifically because few, in their boom-era delirium, had foreseen that the wave, so long cresting, must eventually break. When, on that Black Monday, the stock market did actually crash, and when bankruptcies and layoffs followed on its heels, the country was unprepared—due to ideology as well as limited governmental infrastructure—to deal with the economic repercussions.

A similar pattern has shown up presently. Thus, this paper would look into the different aspects of Credit crunch. It would look into the parameters of the policies formulated and implemented by the Federal Reserve Bank. It would also evaluate the probable development in the near future and the would draw attention to similar problems in near past and the measure taken. Throughout, I will adhere to the following table of contents: