

Financial Chaos

*Extract from article by Anatole Kalesky – Economist
Sunday Times London UK, Sunday September 15, 2008*

To understand the underlying reason why the enormous deleveraging triggered by the still-expanding financial crisis is doing much less damage than generally expected to the real economy, consider the following example: before the arrival of "hyper-finance", if a family wanted a £100,000 mortgage they would go to the Halifax and simply borrow £100,000. Now consider what would have happened in the new financial world. The family would have borrowed £100,000 from Northern Rock, which would sell £100,000 of bonds to hedge funds, which would buy these bonds with £100,000 borrowed from Bear Stearns, their prime broker, which would raise this money by selling £100,000 of commercial paper to Citibank, which would then borrow £100,000 through the inter-bank market from Halifax. The original borrower is still the same household and the ultimate lender is still Halifax, but now a £100,000 mortgage has created £500,000 of new debt.

In theory, this entire chain of transactions could be squeezed, like a concertina, back to the original £100,000 loan between the homeowner and Halifax and the total credit in the banking system could be reduced by 80 per cent, with very little effect on the real economy. The reality would not, of course, be quite so simple. The huge reduction in credit would leave the final borrower and the ultimate lender exactly where they were before, but all those intermediate transactions would vanish, with related jobs and profits. The unemployed bankers would have less money and their loss of spending power would, in turn, hit consumption and housing in a second-round deflation. Moreover, many imprudent financial products created in a world of unlimited leverage, for example 100 per cent mortgages, would disappear. And tougher lending conditions would, in turn, push down those asset prices on leverage, especially housing.

In short, the real economy would weaken, but not to the disastrous extent apparently implied by the scale of the financial crisis. This seems a reasonable description of conditions in the world economy since the credit crunch started – and they will probably continue at least until the end of this year.