

The crunch is poised to take its toll on global growth

By David Roche

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The credit crisis is almost a year old. To begin with it was seen as nemesis for financial sector hubris. Many thought that, with the exception of the construction sector, the "real" economy would be unaffected. That dream is fading. But the economic impact took a long time to unfold. The explanation lies in the complicated nature of what constitutes "liquidity". Traditionally, liquidity has been measured as broad money or credit - more or less matching the flipside of banks' balance sheets.

The amount of credit banks create is a function of several variables. But let's focus on two: leverage and the credit multiplier. Usually about \$8-\$10 of credit is created for every \$1 of banks' risk-free capital. "Power money" is money central banks inject into the banking system. It also limits bank credit. Banks can lend out power money only a finite number of times. The exact number, or "credit multiplier", is set by the amount of precautionary reserves banks make for each loan.

At Independent Strategy, we estimate that banks and brokers will destroy globally \$1,000bn- \$1,400bn of their own risk-free capital owing to losses on all forms of credit in this crunch. Global credit contraction should fall by 8-13 times the amount lost. But this figure has to be adjusted for future retained earnings and capital-raising. Do that, and you are left **with a reduction of 5-7 per cent in global credit.**

It doesn't sound like a lot. But consider this. If the global economy were unaffected by the credit crisis and continued to grow 5-8 per cent in nominal terms, **total credit (including bank lending and other debt) would have to grow 20-40 per cent to fund this increase in gross domestic product.** That's because we use \$4-\$5 of new credit for every \$1 of GDP growth.

So even a standstill in total credit outstanding is a credit crunch.

In the two regions most affected by the credit crisis, bank credit has grown merrily. In the euro zone, bank credit was expanding by 10 per cent per annum in April, although loan growth is plummeting. In the US, total bank credit began to contract only in the past three months to mid-June. So where's the credit crisis?

Of course, intuitively everyone knows the credit crisis is for real. The securitized debt and money markets provide irrefutable proof of this, with many debt categories contracting by 30-80 per cent measured by new credits issued. In money markets, interest-rate spreads remain at crisis level. In credit insurance markets, prices reflect the crisis too.

So credit contraction in securitized debt and money markets is one reality. The other is the absence of bank credit contraction. The liquidity provided by securitized debt and money markets is used predominantly to trade assets. Bank credit is a transaction form of money used to buy goods and services. This "shopping" money is still being created by the banks and spent by consumers and businesses and to finance corporate investments in the "real" economy.

And, of course, bank lending is being funded and underwritten by every form of fiscal and monetary policy tool available to the authorities.

But liquidity injections by central banks can only postpone the day of reckoning when the **real problem is bad assets and the insolvency of financial institutions**. The same is true for bail-outs of financial institutions that result in **the socialization of risk**. With bank credit now contracting in the US, and soon to do so in the eurozone, global bank credit, the most potent form of "transaction" money (shopping money) that nurtures demand in the real economy, is set to fall and, with it, global growth.

This is when the great unsung evil of the disinflationary era, **the substitution of leverage for thrift, goes into reverse**. This can only happen with **elimination of excess consumption** and **falling living standards in the US**.

The fallout will be a paradigm shift for emerging economies that are over-concentrated in investment, output and export of manufactured goods used to sate the bloated appetite of over-indebted consumers in rich countries. These export markets are about to dry up. Vast swathes of emerging market manufacturing capacity will lie idle. This is possibly the next big shock to the system: the end of the great China miracle story.

The writer is president of Independent Strategy, a London-based investment consultancy