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**To:** "" <michael@intrafi.com>



## Credit Crunch Report



*Where the U.S. Treasury has invested \$250 billion into  
banks*

[Source: U.S. Department of the Treasury](#)

Friends, our apologies for our recent delivery outages. We have made the necessary adjustments and should be back on schedule next week.

But first, let's conclude our look at what the Congressional Research Service (CRS)-- Congress's own nonpartisan think tank--has told

both Democratic and Republican members of Congress about what's wrong with the U.S. economy. We've reviewed CRS reports that summarize the [current recession](#) and that explain the [widespread financial crisis](#). Today, finally, let's speed read the CRS report on the credit crunch.

This report addresses why credit is tight, who tight credit is hurting, and what the U.S. Federal Reserve and the U.S. Treasury have tried to do about it. Again, it's complicated stuff, but the economists who work for all the members of Congress have made it as simple as they can.

### ***Tight Credit***

"The act of borrowing short-term and lending long-term makes financial institutions less liquid and therefore inherently vulnerable to crisis. It is a sustainable situation, however, so long as there is widespread confidence, particularly among lending institutions themselves, in the quality of the assets being created."

"The current turmoil in U.S. financial markets is the result of a breakdown in that necessary confidence. In an environment of distrust, financial institutions are less willing to lend long-term. While still willing to borrow short-term, in the face of great uncertainty they will tend to also lend short-term in an attempt to enhance their own liquidity."

"They prefer to hold riskless Treasury securities that offer almost no return rather than lend to a business or consumer who presents even moderate risk."

### ***Tight Credit Crunches Residential Investment***

"So far, the effect of progressively tighter credit conditions in 2007 and 2008 has been most evident on real residential spending, which is highly sensitive to changes in the price and

quantity of mortgage lending."

"The inventory of unsold homes was reported to be around 4.5 million units, or equivalent to about an eleven month supply. Similarly, housing starts have fallen precipitously, from over 2 million units in 2006 to an annual rate of about 800,000 units through September 2008, or a total decline in housing starts of about 60%."

"A significant factor in the sizable decrease of residential investment has likely been a sharp slowing of the flow of mortgage credit from lenders. As recently as the fourth quarter of 2007, mortgage lending to households occurred at an annual rate of \$635 billion, but that flow had diminished to \$81 billion by July 2008."

### ***Tight Credit Crunches Business Investment***

"Real non-residential investment spending continued to increase in 2007 and the first half of 2008 despite the growing turmoil in U.S. financial markets."

"Since then, the rate of increase has been slowing. After advancing 7.5% in 2006, the pace of spending by businesses on new plant and equipment slowed to 5.0% in 2007, and through the second quarter of 2008 that pace had slowed to about 2.3%. In the third quarter of 2008, real non-residential investment declined 0.1%."

"The fall of real non-residential investment in the third quarter of 2008, although small, suggests to some that for many businesses a point has been reached where a dwindling flow of credit is a significant constraint on non-residential investment spending. For most corporations, the primary credit constraint is not likely to be a lack of bank credit but the inability to issue bonds on affordable terms."

### ***Tight Credit Crunches Consumer Spending***

"Until recently, the flow of credit to households (other than mortgage lending) was not greatly diminished. As recently as the fourth quarter of 2007, bank loans to households increased at an annual rate of nearly \$63 billion."

"Yet by the second quarter of 2008, bank loans to households *decreased* at a \$52 billion annual rate. This diminished flow of bank credit could constrain many types of consumer purchases, such as autos, major appliances, and higher education. . . . These are expenditures that are typically financed by borrowing."

"In contrast, the flow of consumer credit (largely credit cards) has remained relatively strong through the second quarter of 2008, down from an annual pace of \$136 billion in 2007 but still increasing at a \$114 billion annual rate in the second quarter of 2008. This pattern of borrowing probably indicates that households have been running up their credit card balances to sustain their spending."

### ***The Fed's Fight to Loosen Credit***

"As the 'lender of last resort,' the Federal Reserve offers credit to solvent but temporarily illiquid financial institutions. These financial institutions are solvent because the value of their assets exceeds the value of their liabilities. But because their debts tend to be short-term and liquid while their assets are long-term and illiquid, they are in need of short-term funds to meet short-term debt obligations."

"The Fed's discount window is its facility for making loans to financial institutions with short-term liquidity problems, and the discount rate is the interest rate charged for these loans. . . . The Fed's enhanced discount window initiatives have pumped a large volume of liquidity into the U.S. financial system."

"For the two-month period ending October 1, 2008, the Fed increased systemwide reserve funds by over \$800 billion, increasing total reserve funds to over \$1.5 trillion. For comparison, reserve funds increased only about \$27 billion over the twelve months ending June 2008."

"Despite their size, the Fed's lender-of-last-resort initiatives (along with conventional monetary stimulus) have not yet resulted in renewed credit flows, as financial institutions have accumulated reserves, but remained reluctant to generate new long-term lending. This lack of effect has suggested to some that the problem goes beyond short-run illiquidity and involves long-term solvency issues."

### ***The Treasury's Fight to Loosen Credit***

"Hence, the Troubled Asset Relief Program (TARP) was initiated. . . . The heart of the program is that it gives the Secretary of the Treasury up to \$700 billion to either buy mortgages and other troubled assets or directly recapitalize selected financial institutions."

"Arguably, the government will now target, as it does the federal funds rate, the price of risk in the economy. Stabilizing the price of risk may reduce the incentive of financial institutions to hoard liquidity and induce them to return to their role of borrowing short-term and lending long-term, and begin to pass a larger flow of liquidity to the non-financial sectors to support credit dependent spending."

"In general, there are at least two ways for TARP to stop the price of risky assets from falling. First, the Treasury can reduce the supply of risky assets by buying them or guaranteeing them (a guarantee reduces the supply because it transforms a risky asset into a not-risky asset)."

"Second, the Treasury can recapitalize the

financial system either through inducing it to capitalize itself or through the government taking some level of equity position in troubled financial institutions. With recapitalization, the demand for risky assets is expected to recover, exerting upward pressure on asset prices. The initial spending of TARP funds has been for recapitalization."

*--Michael Himick*



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