The Credit Crunch

You may have heard people talking about the 'credit crunch'. Your parents and teachers may refer to it, and the newspapers are still full of it, but what does it mean?

The credit crunch

A credit crunch is a worldwide reduction in the amount of money that is available for people and businesses to borrow to pay for things. So how and why did the recent credit crunch happen?

How financial organisations work

Banks rely on people depositing money into their savings accounts. They have to keep a percentage of this money safe, called 'capital reserve', but they use the rest to make investments and lend to people and organisations. They also lend large amounts to other banks and building societies. They make money by charging interest on all the money they lend.

How did the recent credit crunch start?

The 2008 credit crunch started in United States of America where most of their economy is funded by loans from banks:

- People borrowed money (e.g. for mortgages to buy houses or for investments).
- Businesses borrowed money to expand.
- Banks even lent money to people on low incomes and with poor credit ratings, who found it difficult to keep up their repayments.
- Some people who had taken out mortgages couldn't keep up with their repayments and banks had to repossess their houses to resell and get their money back.
- Businesses saw a drop in sales because many people were having financial problems and some people even lost their jobs as well as their houses.
- So businesses also had difficulty repaying their debts and loans.
- The Stock Market (where shares in companies are bought and sold) began to have problems, as people were unable to invest their money.
- Banks started to ask for the money they had lent each other back, but almost every bank was in the same situation.
- Banks all over the world are connected, as they lend and borrow from one another. When the American banks reduced lending, financial organisations around the world were forced to do the same.
- As you can see it is easy to get into a downward spiral of economic activity.

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The Credit Crunch cont'd

How has the credit crunch affected people in the UK?

- UK banks couldn't get back money they had lent and started to hold onto the money they had, making it difficult for people and businesses to get mortgages and loans.
- With people having little money to spend, businesses have suffered. Many have become insolvent (financially ruined) and closed down.
- With businesses closing or reducing staff to cut costs (downsizing), many people lost their jobs or had pay cuts, so had less money to spend.
- Businesses and individuals having little money meant less money has gone to the Government in the form of Income Tax, Corporation Tax and National Insurance.
- With so many people out of work, the Government has also had to pay out more money than usual in benefits.

The Government has made a number of decisions to try to help the economy:

- It's lending money to some UK financial institutions in order to help them through their financial difficulties.
- The Bank of England has reduced interest rates, encouraging building societies and banks to do the same. While this is bad news for savers, as they will receive less money in interest, lower interest rates mean that it's less expensive for people to borrow money.
- The Government even cut the rate of Value Added Tax (VAT - an additional payment on goods and services) from 17.5% to 15% to encourage people to spend money sooner rather than later. It went back to 17.5% in January 2010 and was increased to 20% in January 2011.
- The money difficulties caused by the worldwide credit crunch have meant that the UK economy fell into a recession, with the economy 'shrinking'. This means that the country will have less money as it will produce fewer goods and services (these are known as the Gross Domestic Product). That is why it is more important than ever to be careful with your money.