

Etsior Monthly Opinion 15 June 2009 - Credit Tightening

It may seem to be a paradox to talk about credit tightening while we are well within the recession; though some hints may let us believe we are at the bottom, the situation is still not cleared up.

When we look at the structural change the American consumer is experiencing, as he goes from being a big credit user to become a net saver to rebuild a minimum of his savings, we may think that we are not yet at the point of recovery and that it will take a lot of time.

When we consider that credit linked to securitization is scarce, that it should not be available again until the "shadow" banking system is able to lend money against *negotiable* collaterals, then we can really doubt there is a need for credit tightening.

At the same time, the credit crunch is losing intensity as only about 40% of banks are now tightening their credit conditions. The demand for credit is low, though picking up in the last weeks; this shows a slow recovery. Lending rates are at historical lows and this should incite borrowers to ask for more credit.

We also see this huge inflow of money which is being brought by the governments and the central banks, which ultimately will make the economic engine restart. Hence, we can only consider this will obviously spur inflation, maybe not tomorrow, but probably in the next months.

The German chancellor, Mrs. Merkel, has recently asked for tighter economical measures from the European Central Bank (ECB), as she is afraid of a quick return of inflationary pressures. People, as well as companies, are still stunned by what happened in 2008 and are just waiting, sitting on huge liquidities. When inflation is picking up again, then the imbalance will be visible.

Monetarists state that inflation and unemployment are correlated. In other words, unemployment does not mean there is no inflation. And in fact it is what happened during the great depression.

To address inflation governments and central banks will have to massively reduce liquidities. This can be done through different ways: by selling government bonds (drying up the market), by increasing taxes, by increasing interest rates, by drastically reducing the budget deficits or by a combination of these actions. The Fed, as well as the other Central banks, have done

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what they had to do to avoid a collapse of the economic system and a even greater rise in unemployment.

They have done it under the pressure, or in accordance, with the markets and the social and economic protagonists. By the way, this shows Central banks are independent only up to a certain point. Then will come time when they will have to address inflation.

The Bank of England has already said it would increase its lending rates as soon as inflation is starting again. Do not forget than in a few months (October 2008 to March 2009) the Bank of England reduced its lending rate from 5% to 0.5%! Such a situation cannot last. And the ECB will without any doubt follow or act concurrently. Not doing so would mean a strong return of inflation which would hurt basically the people beneficiating from pension money, mainly retired people. Some people will tell you governments will be happy to have some degrees of inflation as it will make the pension bill easier to pay for the younger generations. It may be, but the inconvenient would also be non negligible, as socially unbearable. If, especially in Europe, retired people begin to see a significant lowering of their income, they will ask the governments to compensate, which can only be done through a tax increase (for example the VAT rate, already high).

This is why we believe that in the coming months, without being able to be more precise, we'll see higher interest rates. Those who have the possibility to borrow or renegotiate their loans at current levels should do it on fixed interest rates terms. This is a one time opportunity.

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