



## Why does the Credit Crunch matter?

The so called 'credit crunch' has come about because of underlying problems with the money supply in the banking system. But why is the money supply so important?

It is over a year since news broke that HSBC was to write off \$11bn due to problems in the sub-prime market. Since then, phrases such as "credit crunch" and "liquidity crisis" have become ubiquitous.

To understand why central bankers are concerned about current problems, one has to appreciate the importance of money.

Without money, there would be no medium of exchange and trade would revert to using barter. Barter is where you exchange what you produce; e.g. a publican who wanted to educate her children would need to find a teacher that wanted a pint of beer.

Money overcomes this problem by providing a medium of exchange that is accepted by everyone. Indeed, I doubt that mankind has made a more important invention than money.

For the economy to grow we must improve output, and to do this, we need to increase the quality of what we provide and/or reduce the cost of providing it. This generally requires new systems, factories, buildings, etc, and all of these require capital. So if capital is not available the economy stagnates: we may not improve our home, a company may not buy a new machine, and an entrepreneur may not be able to launch a new business.

It is for these reasons that central bankers are very keen to ensure that money is available for those who demand it. Money supply is like the blood supply; it carries nutrients to the various parts of the body (the economy) which enable it to function.

If it's inadequate, or damaged, the body suffers. Mervyn King (Governor of The Bank of England) is determined to take action to help improve liquidity within financial markets. Similarly, the US Central Bank (The Fed) and European Central Bank (The ECB) will be keen to maintain an efficient supply of money within their own economies. It is difficult to estimate how long liquidity shortages will last or whether the current situation will worsen.

The strength of the global economy relies on an adequate, and efficient, supply of money. Let us all hope that we are coming to the end of the 'credit crunch'.

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