The Bright Side Of The Credit Crisis

by Chris Seabury (Contact Author | Biography)

A credit crisis, also known as a "credit crunch" or "credit shock", occurs when there is a rapid reduction in the availability of loans from banks. This is caused by loans going sour, forcing the banks to tighten up lending standards.

Credit shocks create both positive and negative effects in the economy. By examining these effects carefully, we can gain a greater understanding of how credit shocks work and what we can learn from them. Read on to find out more.

The Downside of a Credit Crisis

Credit shocks have several negative effects on both consumers and businesses. Some effects are felt right away, while others take time to be seen.

Consumers cut spending

As a credit crunch runs its course, the economy continues to slow. This creates a situation where consumers are less optimistic about the future prospects for the economy and cut back dramatically on their spending. Since consumer spending accounts for 70% of economic activity, even a slight cutback in spending can cause the economy to slow dramatically. (Learn what consumer spending can indicate about the market in *Using Consumer Spending As A Market Indicator*.)

Banks fear making loans

Credit shocks can create a situation where banks are afraid to make new loans. This fear causes many businesses and consumers to cut spending dramatically or even close their doors. This causes a ripple effect in the economy as more businesses have trouble surviving and consumer wealth erodes.

Businesses lose access to capital

When businesses do not have access to the capital they need to expand, pay expenses or pay bills, a liquidity squeeze can occur. This squeeze can force many businesses that have been thriving for years to shut their doors and let their employees go. (Find out how this economic cycle affects both small and big businesses in *The Impact Of Recession On Businesses*.)

Rising foreclosures may bring property values down for communities

If banks are forced to foreclose on too many borrowers, this can have dire consequences on communities. Not only do property values decline in communities where foreclosures are high, but there are several untold economic consequences as well. These include a loss of property tax revenues for both state and local governments, economic blight for areas being affected by waves of foreclosures and the failure of local businesses that are dependent on the community to survive. (Learn what you can do if your home is at risk in *Saving Your Home From Foreclosure*.)

The crisis may force the government to take emergency measures
As the economy becomes weaker and the credit shock spreads from Wall Street to Main Street, a cycle of economic weakness spreads throughout the country, creating rising unemployment and negative growth. This forces the government to take drastic measures to break the cycle once and for all by spending hundreds of billions of dollars to revive the economy. (Learn what measure the Federal Reserve takes in this situation in *The Federal Reserve's Fight Against Recession*.)

A falling stock market eats away at wealth
The credit shock and uncertainty about future earnings cause many investors to sell their stock holdings and move into safer investments. This causes the equity market to go into a free fall that eats away the values of 401(k) plans, IRAs and pension plans. Diminished nest eggs force many who were planning on retiring to work longer. (Learn how understanding the business cycle and your own investment style can help you cope with an economic decline in *Recession: What Does It Mean To Investors?*)

Consumers and businesses feel panic and fear
Left unchecked, the credit shock can create a loss of confidence in the nation's financial system. This causes many people to assume the worst and take drastic steps to protect what little wealth they have left. It is at this point that bank runs become more common and even more financial institutions collapse. (Learn how the SIPC and FDIC insure against personal financial ruin when banks or brokerages go belly up in *Bank Failure: Will Your Assets Be Protected?*)

The Upside of a Credit Crisis
Credit shocks can create many lasting, positive changes. These changes can be seen in the aftermath of the crisis. Some of the positive effects of a credit shock include the following:

The economy cleans out excessive debt and spending
During good economic times, many businesses and consumers increase their overall debt. This behaviour is fuelled in part by businesses needing to expand and in part by consumers who are feeling good enough about the economy to make large purchases without worrying about what will happen in the future. (Read *Five Signs That You're Living Beyond Your Means* to learn whether you're in this risky group.)

But while the economy will continue to expand and debt levels consistently rise for a while, at some point the economy will slow down and many who overextended themselves during the good times will be forced to live within their means or may even fall behind. As businesses and consumers are forced to cut back, some will stop making payments on their debts, forcing financial institutions to write the bad loans off. These forced write-offs, either by the banks themselves or through government intervention, will cleanse the financial system so that businesses can have strong balance sheets and consumers who were once tapped out can increase their spending without being burdened by large amounts of debt.

Corporations clean up their balance sheets
Businesses can use debt to expand and increase their overall profits. However, debt can be a double-edged sword: during recessionary times, the amount of overall debt that businesses took out during the last expansion can cause the company to face liquidity problems. By writing off the bad debt on their balance sheets, businesses become leaner, can weather the slowdown and can expand even more when positive growth returns to the economy. (Learn about the role of debt in determining corporate health in *Debt Reckoning*.)

Transparency and regulation in the financial sector improve
A financial crisis can expose the loopholes in regulations that people were taking advantage of - loopholes that may have contributed to the crisis. The government then reacts by creating new regulations to address the situation. Over time, these laws bring confidence back to the U.S. financial system and investors feel secure again. (Learn about the role of confidence in the economy by reading *Understand The Consumer Confidence Index*.)

Hard times force consumers to regain control of their spending
During times of expansion, many consumers try to keep up with the Joneses by living a lifestyle beyond their means and accumulating more debt than they can handle. Credit shocks force consumers to rein in their spending and lead lifestyles that are more appropriate to their incomes. People then regain control of their finances and cause the national savings rate to increase. (Learn how to keep your spending under control every day in *Squeeze A Greenback Out Of Your Latte* and *Nine Reasons To Say "No" To Credit*.)

Declines in stock prices create great long-term valuations.
During the crisis, when everyone is panicking and selling both good and bad investments, many smart investors are buying those good investments and holding them long-term. Once the crisis is over and the chaos has died down, they make tremendous profits. Some of the more well-known investors that have employed this strategy, include Warren Buffett, Sir John Templeton and Benjamin Graham. (Bear markets can terrify even seasoned investors. Learn how to invest safely in *Four Tips For Buying Stocks In A Recession*.)

Conclusion
Credit shocks have many negatives, but they also create opportunities. During times of economic crisis, it is important to keep a clear head and not get caught up in the fear. Left unchecked, large-scale fear can wreak havoc on the world economy. But over time, the crisis will end and the economy will begin to expand once again.

For further reading, see *Five Strategies For Surviving Tough Times*, *Taking Advantage Of Corporate Decline* and *How does a credit crunch occur?*

by Chris Seabury, (Contact Author | Biography)