Causes of the current crisis [1]

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Credit contraction has featured in depressions since ancient times. The ?Credit Crunch" we are currently experiencing is primarily due to three factors: (1) the natural human tendency to irrational optimism and pessimism in certain circumstances; (2) the creation of huge amounts of new money through bank credit expansion by central banks and the Fractional Reserve Banking system; (3) quasi governmental enterprises such as Freddie Mac and Fannie Mae in the US (involved in 95 percent of all 2007 US mortgages).

Factor (1)?s effects are obvious; these effects naturally cause and exaggerate cycles. People are optimistic on the way ?up" (a boom) and pessimistic on the way ?down" (a bust). This by itself, however, is insufficient to cause a boom of the type we have seen. Prices in general can only increase with either an injection of money into the market, or a decrease in the demand for money. If no money were created, a price boom in one market would coincide necessarily with falling prices elsewhere. This would lead to a natural and speedy reasserting of real preferences if some products were undervalued and others overvalued.

Factor (2) is less obvious. Direct government action, as well as its tolerance of fractional reserve banking, gives the illusion to business that more savings are held than there actually are;. Banks offer loans at lower prices due to their greater ability to do so (supply has risen with regards to demand) and this encourages greater investment. This leads firms and entrepreneurs to believe the consumption to savings ratio is more tilted towards savings than it actually is, and thus they invest more, and in more producer goods. Savings are necessarily future consumption, so businesses invest in anticipation of this, and because it costs less to do so. This ?malinvestment" is revealed when the process of monetary expansion ceases. Then comes the ?bust", and, as savers see through fractional reserve banks, there is a contraction of money and credit (deflation) as the bankrupt and unprofitable enterprises are liquidated through runs or closures. Factor (3) has worked similarly to (2), depressing the price of savings under their market price.

So it is essentially government interventions in the market, especially through central banking and artificial money creation, together with natural human tendencies, which created the bust whose effects we are now experiencing.

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