Shrinking Credit Lines May Be Bad News for the Economy

July 29, 2010 - Three years ago, the United States began to enter a financial quagmire that continues through this day. It started when investors refused to continue buying financial securities backed by shaky mortgages. Within a year, banks pretty well stopped lending to virtually everyone. They also started reducing consumer credit limits, raising fees, raising interest rates and dropping customers that they considered to be too high risk. These reactions caused a consumer backlash that led to legislation restricting credit fees, limiting interest rate increases, and more recently to a financial reform that further targets the profit centers of big banks. While the legislation may have sounded good to many consumers, it was poorly crafted and could wind up being responsible for further reductions in credit, reduced consumer spending and a retraction of the US economy overall. That's not good news for job seekers, employers or virtually anyone else.

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Before credit markets started to fall apart, consumer credit was widespread and easy to get. Consumers had access to $4.7 Trillion of spending power on credit cards alone. That number has been reduced to $3.3 Trillion today. According to Oppenheimer & Co, that number may wind up being reduced by another $2.1 Trillion over the next year.

Since the US economy is driven by consumer confidence and consumer spending, such a large retraction in credit is likely to lead to further economic weakness. In all likelihood, it will mean more job losses and significantly slower growth.

While there is no doubt that banks extended credit to many people who couldn't afford to repay their loans, the largest part of those problems are behind us. The reason for the predicted credit retraction over the next year is largely due to recently passed congressional legislation.

Many of the credit card restrictions that have already gone into place were sorely needed within the industry. Lenders, many of which were abusive in their practices, were looking for ways to increase consumer fees in virtually all areas of their businesses. The recent restrictions on those fees insured a more even playing field for consumers. It stopped practices such as making a bill due on Sunday - a day with no mail delivery - and then charging late fees if payment was not received until Monday morning. It also placed significant restrictions on arbitrarily raising interest rates. At the same time, it preserved lenders ability to raise rates on customers that were ignoring their repayment obligations.

Lenders didn't see it that way though and they found other areas of their business in which they could raise fees.

More recently, Congress passed financial reform legislation that regulates other areas of the banking industry. Again, the bill regulates some banking fees, including swipe card fees that merchants pay when a credit card is used. This particular bill is already having consequences.

Credit cards without annual fees and free checking are the first victims. Wells Fargo has already stopped offering free checking. Other banks are experimenting with fee structures. Using credit cards vs. cash is also likely to become more expensive and more difficult. That's because the new law allows merchants to offer discounts for cash and to set minimum purchase limits for the use of any credit card.

The irony of this is that the latest legislation, which was supposed to protect consumers, is already hurting them. That trend is apt to continue as the law is implemented around the country. What is certain is that if banks do cut back on credit limits to the tune of more than $2 Trillion over the next year, it will be a very long time before we see anything that looks like a sustainable economic recovery.

byJim Malmberg

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