The Bank cut rates in December and February by a total of 50 basis points (0.5 percentage points) to 5.25% but the sharp rise in Libor rates at which banks lend to one another in recent weeks has pushed up mortgage rates as banks retreated from risky loans and sought to rebuild their profit margins.

In last month's budget, the chancellor forecast that the British economy would grow 1.75%-2.25% this year, after 3% last year, and bounce to 2.25%-2.75% in 2009. Most independent forecasters are considerably more gloomy than the Treasury, fearing that the credit crisis could curb growth more than Darling is assuming.

In the past two weeks, a succession of lenders have either withdrawn mortgages or raised the interest rates on them, in the latest sign that the problems in interbank money markets are spilling out into the wider economy.

There were some small signs of an easing in money markets yesterday as Libor market interest rates enjoyed their biggest fall since January. Three-month sterling Libor fell by more than three basis points to 5.95%, though that is still way above the Bank of England's official Bank rate of 5.25%. Libor rates have remained elevated because of a reluctance among commercial banks to lend to each other for fear of what toxic, worthless financial instruments each might be holding.

Darling said in his letter that he strongly supported the work being done by the Financial Stability Forum (FSF), whose recommendations are to be presented this week in a report the chancellor welcomed.

"I particularly welcome the FSF's proposals on prudential regulation of banks, risk management and disclosure by financial institutions, transparency in securitisation markets and credit rating agencies."

The chancellor said he wanted the FSF and IMF to work more closely together in future to provide early warning of financial crises and to better coordinate a response to them.

Europe has already said it will press the G7 to demand more disclosure from banks on their investments as the credit crunch spreads from the financial sector to the household and corporate sectors.

The bubble over Britain

The City of London is by nature exuberant. The UK's real threat lies in its overvalued housing

Gavyn Davies

The City of London is by nature exuberant. The UK's real threat lies in its overvalued housing

The mood in the City of London is bleak as the markets come to terms with the credit crunch that has ended the first financial boom of the 21st century. Beginning in 2003, a leverage bubble, driven by easy borrowing, fuelled robust growth in the global financial services industry, and the London economy was at its centre. Now it's payback time.

Irrational exuberance, as Alan Greenspan called it, is a permanent and possibly unavoidable feature of financial markets. This latest episode, though, was triggered by Greenspan's own decision to reduce US interest rates to about 1% as the earlier bubble in technology stocks burst in 2001. Greenspan was hailed at the time for his bold action, but the unintended consequences of such low rates were profound.

The financial services industry is never slow to take the opportunity to make a quick profit. That is its greatest strength – but is also the source of its inherent vulnerability. With central banks in the US and Japan providing unprecedentedly easy money, investment and commercial banks found no shortage of ways to channel that money into the rest of the economy. Rapid rises in property prices became the norm in many economies, and hedge funds adopted strategies which relied on buying assets worth many times the money they actually owned to generate high returns. Private equity firms similarly relied on borrowed money to acquire companies which did not necessarily have the underlying profitability to finance the debt.

For the most part, Britain imported the adverse effects of this bubble. Admittedly, the Financial Services Authority has been criticised for its failure to intervene earlier in Northern Rock's reckless strategy, but in the greater scheme of things this error was inconsequential. And the Bank of England did little to fuel the boom, keeping interest rates much higher than the international average.

The reality is that global finance is now a single marketplace, so the cheapness of money available in dollars and yen worked against Mervyn King's efforts to keep sterling credit expensive. And London, without question, is now the capital of global finance, so it is bound to benefit when worldwide financial services enjoy a surge. In the old days, these effects were felt mainly in the Square Mile, London's historical financial district, but then along came Canary Wharf, and recently hedge fund alley – that is, Mayfair. On my guesstimate, Mayfair's GDP in recent years has outstripped that of about a third of the countries on this planet. Parts of London's economy and property market will inevitably feel the pinch as these masters of the universe retrench.

How bad will the leverage collapse prove for Britain as a whole? This needs to be kept in perspective. Although financial services account for 7.7% of the economy and 4.1% of employment, most of this activity is in routine domestic banking and insurance, and not in investment banks and hedge funds. According to Ben Broadbent at Goldman Sachs, the City's share of output is only about a quarter of the size of the manufacturing sector. A sharp contraction in financial services would, therefore, dent the UK's growth rate, but not sufficiently to cause a recession.

A much more serious problem, however, stems from the housing sector. In a study just released by the International Monetary Fund, UK house prices are calculated to be 27% above the rate suggested by underlying fundamentals. Only two countries, Ireland and the Netherlands, have more severely overvalued markets. It is far from clear that recent UK price rises have been triggered by the global leverage bubble – the IMF evidence seems to point in the other direction – but it is clear its collapse threatens to cause a severe correction. This, rather than the downturn in the financial sector, is the real threat to the stability of Britain's economy. And the Bank of England needs to address it urgently, starting by cutting the bank rate on Thursday.

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