The words coming out of Washington this week about the American financial system have been frightening. But many have raised the possibility that the Bush administration is fear-mongering to gin up support for its $700 billion bailout proposal.

In many corporate offices, in company cafeterias and around dining room tables, however, the reality of tight credit already is limiting daily economic activity.

“Loans are basically frozen due to the credit crisis,” said Vicki Sanger, who is now leaning on personal credit cards bearing double-digit interest rates to finance the building of roads and sidewalks for her residential real estate development in Fruita, Colo. “The banks just are not lending.”

With the economy already suffering the strains of plunging housing prices, growing joblessness and the new-found austerity of debt-saturated consumers, many experts fear the fraying of the financial system could pin the nation in distress for years.

Without a mechanism to shed the bad loans on their books, financial institutions may continue to hoard their dollars and starve the economy of capital. Americans would be deprived of financing to buy houses, send children to college and start businesses. That would slow economic activity further, souring more loans, and making banks tighter still. In short, a downward spiral.

Fear of this outcome has become self-fulfilling, prompting a stampede toward safer investments. Investors continued to pile into Treasury bills on Thursday despite rates of interest near zero, making less capital available for businesses and consumers. Stock markets rallied exuberantly for much of Thursday as a
bailout deal appeared in hand. Then the deal stalled, leaving the markets vulnerable to a pullback.

“Without trust and confidence, business can’t go on, and we can easily fall into a deeper recession and eventually a depression,” said Andrew Lo, a finance professor at M.I.T.’s Sloan School of Management. “It would be disastrous to have no plan.”

The Bush administration has hit this message relentlessly. On Capitol Hill, Treasury Secretary Henry M. Paulson Jr. warned of a potential financial seizure without a swift bailout. Federal Reserve Chairman Ben S. Bernanke — an academic authority on the Great Depression — used words generally eschewed by people whose utterances move markets, speaking of a “grave threat.”

In a prime-time television address Wednesday night, President Bush, who has described the strains on the economy as “adjustments,” put it this way: “Our entire economy is in danger.”

The considerable pushback to the bailout reflects discomfort with the people sounding the alarm. Mr. Paulson, a creature of Wall Street, asked Congress for extraordinary powers to take bad loans off the hands of major financial institutions with a proposal that ran all of three pages. Subprime mortgages have been issued with more paperwork than Mr. Paulson filled out in asking for $700 billion.

“The situation is like that movie trailer where a guy with a deep, scary voice says, ‘In a world where credit markets are frozen, where banks refuse to lend to each other at any price, only one man, with one plan can save us,’ “ said Jared Bernstein, senior economist at the labor-oriented Economic Policy Institute in Washington.

And yet, the more he looked at the data, the more Mr. Bernstein became convinced the financial system really does require some sort of bailout. “Things are scary,” he said.

For nonfinancial firms during the first three months of the year, the outstanding balance of so-called commercial paper — short-term IOUs that businesses rely
upon to finance their daily operations — was growing by more than 10 percent from a year earlier, according to an analysis of Federal Reserve data by Moody’s Economy.com. From April to June, the balance plunged by more than 9 percent compared with the previous year.

This week, the rate charged by banks for short-term loans to other banks swelled to three percentage points above the most conservative of investments, Treasury bills, with the gap nearly tripling since the beginning of this month. In other words, banks are charging more for even minimal risk, making credit tight.

Suddenly, people who have spent their careers arguing that government is in the way of progress — that its role must be pared to allow market forces to flourish — are calling for the biggest government bailout in American history.

“We are in a very serious place,” said William W. Beach, an economist at the conservative Heritage Foundation in Washington. “There is risk of contagion to the entire economy.”

Even before the stunning events of recent weeks — as the government took over the mortgage giants Fannie Mae and Freddie Mac, Lehman Brothers disintegrated into bankruptcy, and American International Group was saved by an $85 billion government bailout — credit was tight, sowing fears that the economy would suffer.

The demise of those prominent institutions and anxiety over what could happen next has amplified worries considerably.

“The problem is so big that if somebody doesn’t step in, it will cause a panic,” said Michael Moebs, an economist and chief executive of Moebs Services, an independent research company in Lake Bluff, Ill. “Things could worsen to the point that we could see double-digit unemployment.”

This week, Mr. Moebs said he heard from two clients, one a bank and the other a credit union in a small city in the Midwest, now in serious trouble: Both are heavily invested in Lehman, Fannie Mae and Freddie Mac.
“One is going to lose about 80 percent of their capital if they can’t cash those in, and the other is going to lose about half,” Mr. Moebs said.

The credit union is located in a city in which the auto industry is a major employer — an industry now laying off workers. Yet as people try to refinance mortgages to hang on to homes and extend credit cards to pay for gas for their job searches, the local credit union is saying no.

“They have become very restrictive on who they are lending to,” Mr. Moebs said. “They can’t afford a loss. Their risk quotient is next to zero. You have a financial institution that really can’t help out the local people who are having financial difficulties.”

Along the Gulf of Mexico, in Cape Coral, Fla., Michael Pfaff, a mortgage broker, has become accustomed to constant telephone calls from local real estate agents begging for help to save deals in danger of collapsing for lack of finance.

“The underwriters are terrified and they’re dragging their feet, and making more excuses not to close loans,” Mr. Pfaff said. “Basically, they just don’t want the deals.”

Three years ago, when Cape Coral was among the fastest-appreciating real estate markets in the nation, Mr. Pfaff specialized in financing luxury homes with seven-figure price tags. “Now I’m doing a $32,000 loan on a mobile home,” he said.

Finance is still there for people with unblemished credit, he said. Mr. Pfaff recently closed a deal for a couple in Indiana that bought a second house in Cape Coral, a waterfront duplex for $300,000. Their credit score was nearly impeccable, and they had a 20 percent down payment, plus income of nearly $8,000 a month.

For people like that, conditions have actually improved since the government took over the mortgage giants. A month ago, Mr. Pfaff could secure 30-year fixed rate mortgages for about 7 percent. On Thursday, he was quoting 6 percent.
But those with less-than-ideal credit are increasingly shut out of the market, Mr. Pfaff said, and there are an awful lot of those people. So-called hard money loans, for those with problematic credit but large down payments, were easy to arrange as recently as last month.

“That money has just dried up,” Mr. Pfaff said. “I’m afraid. I’m 54 years old, and I’ve seen a lot of hyperventilating in my life, but I absolutely believe that this is a very serious issue.”