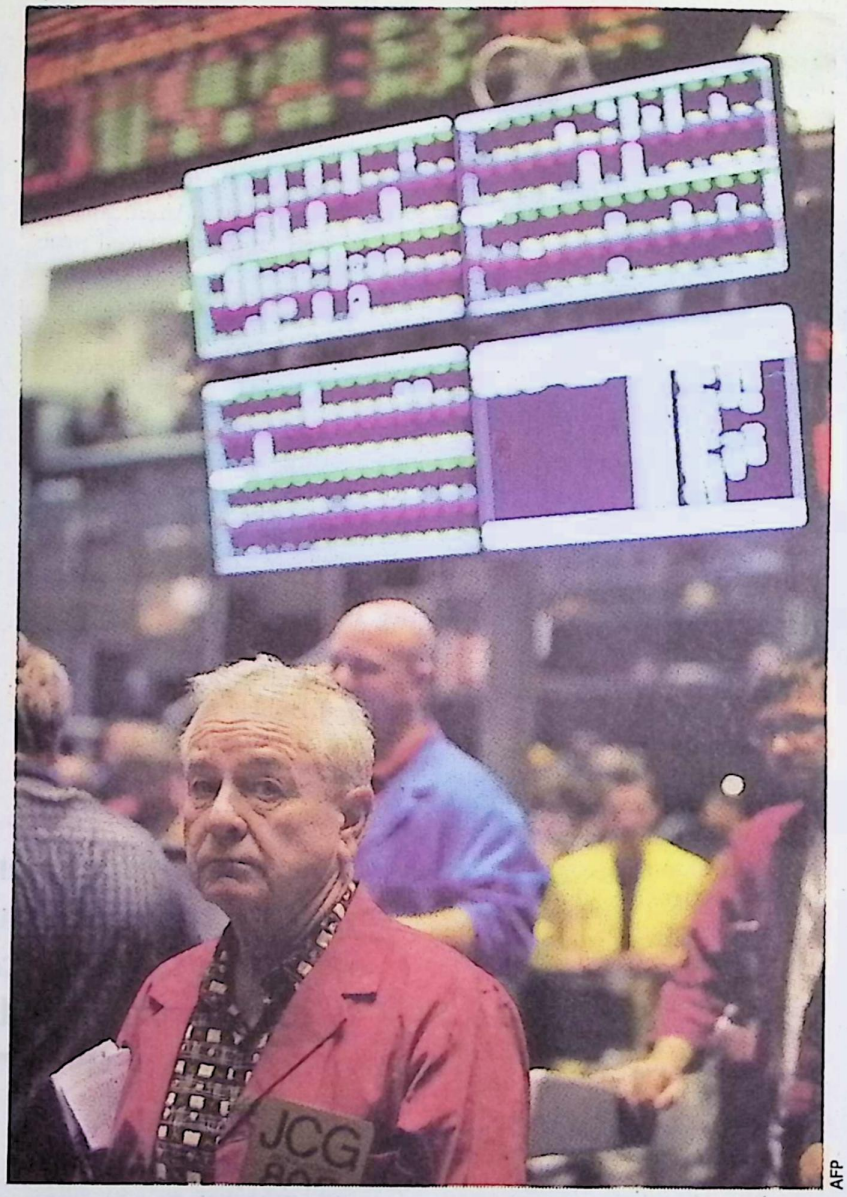
required payment; as the market for housing weakened the increase in house prices stopped, and it became more difficult to use home equity financing as a cushion. At the same time the American economy slowed somewhat, making it even more difficult as people lost jobs, and bonuses and overtime were reduced. There were dramatic increases in the prices of food and gasoline, undermining consumer purchasing power. These price increases also arose from the high demand levels in a rapidly growing world economy.

Expenditures that had been linked to income and home equity loans now slowed with a weakened economy and the closing of the markets for home equity loans. The Federal Reserve lowered interest rates quickly to try to maintain aggregate demand. This had the effect of reducing capital flows into the US but did not really affect the private consumption expenditures as banks did not lower interest rates to consumers, and instead increased them! The reduced capital inflows contributed to a weakening of the US dollar, resulting in reduced imports, higher oil prices around the world, and increased US exports. Internally, the weaker dollar helped American producers of exports but higher gasoline prices hurt households.

Investment weakened sharply in housing, and somewhat in commercial construction and purchase of machinery. As private consumption expenditures weakened, exports rose. The net effect was to slow the growth of the American economy, although it remains positive.

As the world economy slowed down and some conflict zones in Iran and Georgia looked increasingly dangerous, funds flowed back to the US for precautionary purposes, the dollar strengthened, and gasoline prices fell, so things got a little better. But the underlying reality is weak US private consumption demand, weak investment in housing, weak import demand, high oil prices and a weak dollar.



AFP

This has strong implications for the rest of the world, and the naïve ideas that Asia could escape from the impact of the US slowdown we now recognise as wrong. In Asia the Japanese, Indian and Chinese economies are all slowing. Export growth is weaker, inflation is impacting private consumption expenditures, so overall aggregate demand is now reduced, and it is uncertain if this can be countered by domestic demand increases. Certainly, Japan has been unable to achieve this and the Japanese economy continues to rely heavily on export markets. The impact on China and India is clear, as both economies slow while inflation increases. The major European economies are also experiencing slower growth. The major industrial economies are down near zero GDP growth.

Why have the world's financial institutions run into such trouble over the default of a small percentage of the housing loans in America?