write down the value of their assets to protect themselves. Second, they stop making risky loans and seek to place their funds in as safe a vehicle as possible.

Writing down the value of their assets gives them protection against things getting worse -- nobody knows – and they can always recover this if they find that they have marked down their assets too much. Since most managers do not get punished when the values go down, but get rewarded when they go up, this is the way to make money if you run a financial institution.

We can now see the results. Fanny Mae and Freddie Mac have been taken over by the United States government and funds supplied to insure that the two mortgage banks could continue to have sufficient capital, to meet their payments, and continue to fund housing.

There were five investment banks in the United States -- basically unregulated; these took in funds and invested them, much in CDOs, bundled CDOs together to make another CDO to sell, and so forth. As the mortgage payments slowed, CDOs lost value, investment bank assets fell, their share prices fell and they could not raise needed capital.

One of the banks has collapsed, two have been taken over by large commercial banks, and one is in discussion with another commercial bank to sell itself. With the threat of default on the CDOs, AIG was faced with very large potential payments and was taken over by the United States government to prevent this from happening.

Faith in the Financial System is Collapsing.

In conclusion, we have a weakening US economy arising from the housing bubble, the financial markets freezing up as it becomes so difficult to evaluate the quality of assets, American households holding excessive debt and now moving to adjust such debt by reducing consumption, while higher prices further reduce real disposable income.

Although the US national accounts data does not yet show these effects on private consumption it is likely that adjustments in the accounts made over the next few months will show weaker private consumption expenditures. It is likely that aggregate demand in the United States will be weak for one or two more years. Inflation fears may well persuade the Federal Reserve to raise interest rates. This will protect the dollar, reduce inflation, slow investment, reduce export growth; on balance this will reduce GDP growth so as to achieve lower inflation.

I believe that the deficit will increase, but it is possible that American politicians will get serious about deficit reduction. If they do, the world economy will remain in a weakened state.

The weak American economy will affect the rest of the world through reduced imports and higher exports. This will induce slower growth in Europe, Japan, China and India. However, these cumulative effects will reduce the pressure on the price of oil, which will continue to decline. World financial institutions will continue to struggle to understand the real value of their assets.

Will the situation continue to get worse, or can we expect recovery in the next two years? The key to this is the financial sector. Having failed to regulate the financial sector at this point, no one has any clear idea as to what is happening. The most likely direction is a worsening of the condition of the financial institutions; the real economy may be all right but the financial condition of these institutions is more difficult to manage. It is on this that the future rests. If the financial institutions continue to deteriorate then full recovery may be many years away.



How ironic that all the great banks, that have been telling the world what to do, have now been shown to be naked. How ironic that the IMF, explaining to nations like Bangladesh how to run their financial systems, completely failed to warn of the tangle into which the American and European financial institutions have gotten themselves.

Can We Get Out of This?

The world's real economy will recover if the US current account deficit becomes larger and the dollar gets stronger. This will return us to the world of one year ago, when