Strong Ties: The Economy, Crude Oil Prices, and the Iraq Invasion
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Gross domestic product (GDP) is the market value of the goods and services produced in the United States. It accrues as income (with some minor adjustments) to US business owners and income earners. Consumption, the engine of the economy, is contingent on income, particularly disposable income. Disposable income is basically GDP, adjusted for depreciation, taxes, and government transfers.

Economic slowdowns often result from poor fiscal and/or monetary policies that restrict output. The graph below, however, does not indicate any recent decline in output. Rather, it depicts a steady increase in real GDP (income) and real personal consumption from 2002 to 2007. Thus, on the surface, the economy appears to be fundamentally sound.

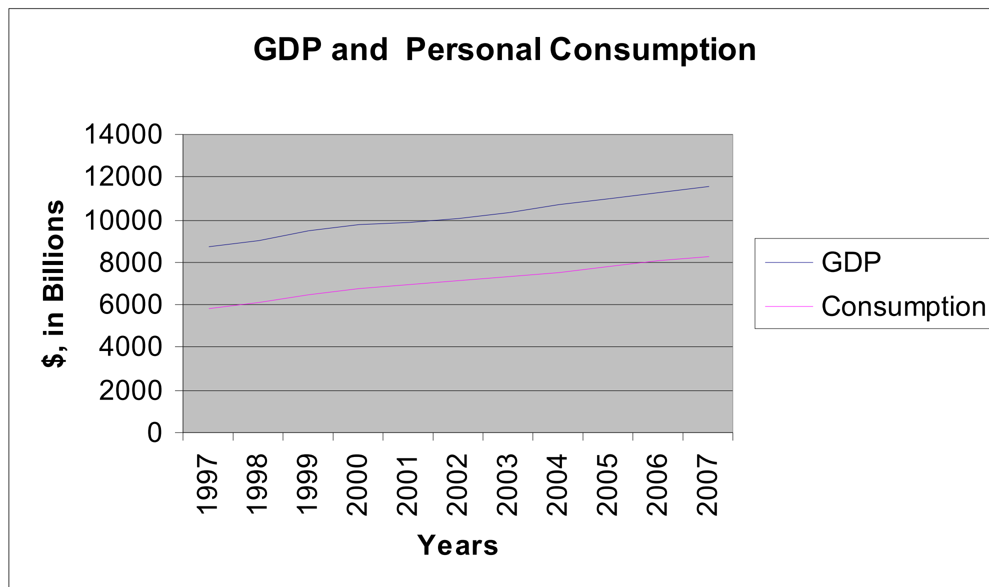

Figure 1 (Data from US Bureau Economic Analysis)

Given a rising US output (income) and personal consumption, in real terms, why are many homeowners unable to pay their mortgages?

It appears that homeowners, and consumers in general, have had to allocate a greater proportion of disposable income to cover higher energy prices. Figure 2 shows the price trend line for US regular retail gasoline from 1991 to 2007. Gasoline prices doubled between 2002 and 2007; this doubling of prices has an adverse effects on the cost of goods transported on highways, as well as on the entire transportation industry. It has negatively affected the budgets of local schools, package carriers, and so on.

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What caused the increase in gasoline prices? The increase in crude oil prices, and hence gasoline, resulted from Middle East instability. Instability causes traders to bid prices upwards. The cause of this heightened instability was the policy decision to invade Iraq. Thus, that policy decision, over time, forced consumers to allocate more of their disposable income to cover the higher cost of energy, food, and other energy related commodities. As a result, homeowners had less income to cover their mortgage expenses, leading to the sub prime mortgage crisis.

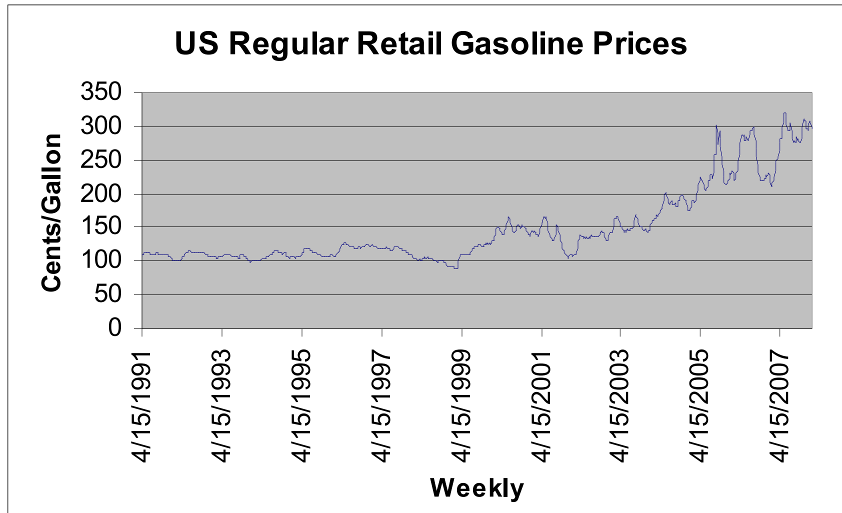

Figure 2 (Data from the Energy Information Administration)

The Iraq invasion also increased government deficit as depicted in Figure 3. The budget deficit is basically government spending plus transfers (including interest payments) minus tax collection. A deficit exist when government outlays exceeds tax revenues. Additionally, whenever saving equal investment, the domestic private sector is in balance and any government deficit creates an equal external deficit. The government funds external deficits by borrowing money from the external sector (foreigners).

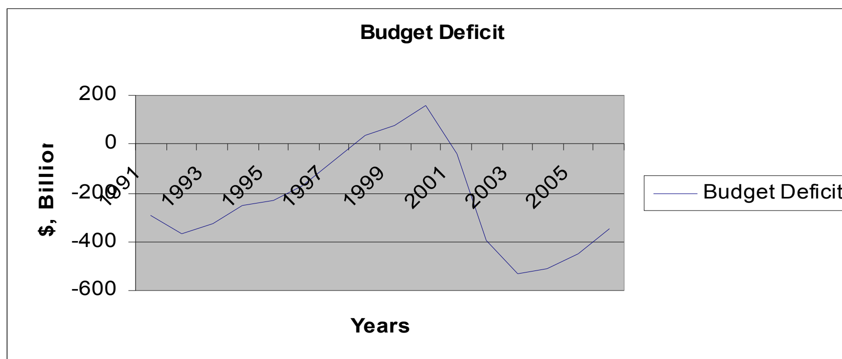

Figure 3 (Data from US Bureau Economic Analysis)

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Given the potential economic slowdown, and the deficit, the Administration, Congress, and the Federal Reserve (Fed) recommended expansionary policies. Accordingly, they argued that expansionary policies would prevent or mitigate the impending recession. Therefore, the Fed lowered the interest rate and monetized the economy, and the Administration worked with Congress to provide over a $150 billion dollars in government transfers.

The transfers will further increase the deficit and external funding, and monetizing the economy is likely to create inflationary pressures: higher prices for goods and services. Therefore, in the long run, neither policy appears to be effective. Furthermore, the actions of the Fed, Congress and the Administration do not mitigate the rising cost of energy, which is the principal cause of the current economic problems. As a result, consumers will continue to allocate more of their disposable income on energy and energy related goods and they might not have enough income to cover their mortgages.

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