Stimulus or no, consumer spending has further to fall

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With incomes pinched, access to credit tightened, and nest eggs dramatically shrunken, Americans are poised to save more and spend less.

Consumers ran squarely into the perfect storm last year, and the wreckage will be washing ashore for some time. The three supports that prop up spending have been devastated: income growth, credit availability, and wealth. Spending, adjusted for inflation, dropped for the second quarter in a row at the end of last year, and another decline this winter is likely. Consumer buying has not fallen for three consecutive quarters since record-keeping began in 1947. Households are in the middle of a wrenching adjustment that will not play out quickly—to the great detriment of economic growth at least through the first half of the year.

Consumers are struggling with years of accumulated debt amid dwindling resources, and they are now forced to begin saving a higher percentage of their income, leaving less for spending. From the end of the 2001 recession to the beginning of the current downturn, the funds required to service overall household debt—everything from mortgages to car payments to credit-card balances—increased by 53%, while aftertax income rose only 38%. During that time, savings as a share of income fell from about 3% to zero.

The savings rate is already heading up, reaching 2.9% of income in the fourth quarter, the highest in seven years. Consumers received two income windfalls in 2008, the tax rebates in the second quarter and the boost to buying power from the plunge in energy prices last quarter. The corresponding spikes in the savings rate suggest they saved most of both.

The problem right now is that households are trying to save a larger share of their income, even as huge losses in jobs and hours worked are squeezing the life out of pay growth. This effort to save tightens the vise on spending even more. During 2008, inflation-adjusted personal income, excluding government handouts, fell 0.9%, after growing 2.1% in 2007.

Making matters worse, households depend more than ever on income growth as a source of saving and spending. Up to now, consumers had no great imperative to save more of their income. Increases in wealth, mainly reflecting capital gains in home values and stock portfolios, averaged roughly $4 trillion annually from 2001 to 2007. Households felt they were saving in other ways, so they spent more of their income. Now, through the fourth quarter, household wealth appears to have shrunk by some $10 trillion, dramatically reducing the size of many nest eggs.

Also, when credit was flowing freely, households had less need for liquid savings, since they could readily borrow to meet emergencies or other one-time needs. Now credit conditions have turned sharply restrictive. On balance, banks continued to tighten their lending standards in the first quarter, according to the Federal Reserve's survey of senior loan officers. The net percentage of banks clamping down on prime mortgages and consumer loans declined from the previous quarter, but it remained historically high, and lenders said consumer loan demand was weak.

The savings rate has further to rise, which will put more downward pressure on spending. All the factors that affect saving behavior are pushing it upward: The drop in wealth relative to income has further to go amid falling home values and moribund stock prices. Credit conditions will not turn favorable soon. And households will likely save a big chunk of the tax cuts in the new stimulus package. Based on historical patterns, many economists expect the savings rate to settle in the 5%-to-6% range last seen in the mid-1990s.

One key to when consumers get back on their feet is how fast the savings rate stabilizes. Compared with the last two recessions, the rise has been fast, but the stress from lost wealth and tight credit is greater, and it will persist for some time. Even with the benefit of fiscal stimulus, it will be a while before consumers are ready to provide the economy with the oomph businesses have come to expect.

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