The end of the affair

America's return to thrift presages a long and deep recession

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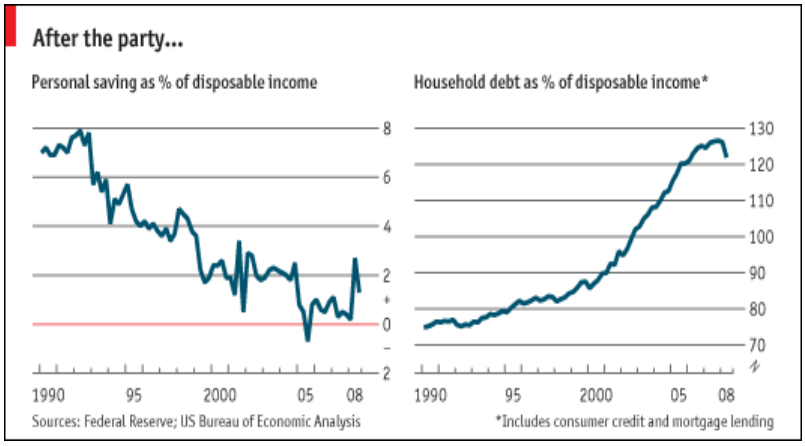
Debbie Jeffries could see it coming. When she manned the cash register at Linens 'n Things, the household-goods chain where she has worked for 14 years, a customer would sometimes open her wallet and display 15 credit cards. "That people can pull out that many credit cards—that's insane. You say, whoa, maybe that's why we're here. We have so much debt."

Ms Jeffries cut up her own credit card several years ago when the balance became unmanageable, but still became an indirect victim of the credit crunch that is now dragging America into recession. Linens 'n Things filed for bankruptcy protection in May; in October, unable to find a buyer for its stores, it began to liquidate itself. A sign in the window of Ms Jeffries' store in suburban Maryland invites anyone interested in buying the fixtures to see the manager. Ms Jeffries expects to be out of a job by the end of December.

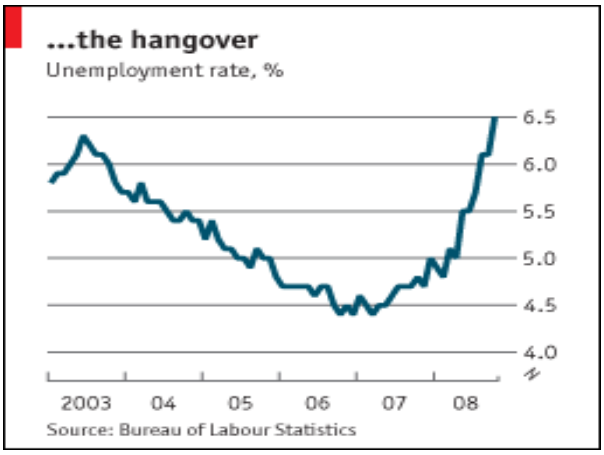


An important reason why the American economy has been so resilient and recessions so mild since 1982 is the energy of consumers. Their spending has been remarkably stable, not only because drops in employment and income have been less severe than of old, but also because they have been willing and able to borrow. The long rise in asset prices—first of stocks, then of houses—raised consumers' net worth and made saving seem less necessary. And borrowing became easier, thanks to financial innovation and lenders' relaxed underwriting, which was itself based on the supposedly reliable collateral of ever-more-valuable houses. On average, consumers from 1950 to 1985 saved 9% of their disposable income. That saving rate then steadily declined, to around zero earlier this year (see chart). At the same time, consumer and mortgage debts rose to 127% of disposable income, from 77% in 1990.

Those forces have now reversed. The stockmarket has fallen to the levels of a decade ago. House values have fallen 18% since their peak in 2006. Banks and other lenders have tightened lending standards on all types of consumer loans.

As a consequence, consumer spending fell at a 3.1% annual rate in the third quarter (in part because tax rebates boosted spending in the second), the steepest since the second quarter of 1980 when Jimmy Carter briefly imposed credit controls. More such declines are likely to follow. Richard Berner of Morgan Stanley projects that in the 12 months up to the second quarter of next year real consumer spending will fall by 1.6%—a post-war record. "The golden age of spending for the American consumer has ended and a new age of thrift likely has begun," he says.

Even before this crisis hit, saving was bound to rise. Baby-boomer Americans have saved far less than their parents, according to McKinsey Global Institute, the consultancy's affiliated think-tank, and are unprepared for retirement. Drawn out over many years, a rise in saving would be a good thing. But compressed into a matter of months, it would be downright dangerous. But the possibility



cannot be dismissed. Bruce Kasman and Joseph Lupton of JPMorgan predict that the saving rate will jump to around 4.5% by the end of next year, the sharpest jump in so short a time in the post-war period.

Patricia Baker, a part-time hostess at a Maryland country club, is spending $1,000 on Christmas this year compared with $3,000 last year. She worries about the economy. People at the club still play golf, but instead of ordering lunch and a beer, many just buy crackers and a soda. She also has less to spend. Illness kept her husband off work for a bit, and they fell behind on payments on their two credit cards. The credit-card company docked his wages to pay off the first, and she is still battling over the second. She expects her monthly mortgage payment to reset next year from $1,700 to $2,000 or more, and doubts she can find anything better: "Banks aren't going to touch anyone that doesn't have perfect credit." She now pays cash—as she did for two pillows in the Linens 'n Things closing sale.

This compulsory return to thrift will be deeply painful; consumer spending and housing are almost three-quarters of GDP. Of the 1.2 million, or 0.9%, decline in jobs since December, about 700,000 are directly related to consumers: retail trade, transportation manufacturing and home-building. The rise in unemployment, from 4.4% in 2006 to 6.5% in October, is nearing that of 2001-03 and is not over. On November 19th Federal Reserve policymakers disclosed they expect the recession to last until mid-2009. Their inflation worries have evaporated; indeed, consumer prices plunged a record 1% in October from September, and by 0.1% excluding fuel and food, the first such decline since 1982. The Fed's vice-chairman, Donald Kohn, said outright deflation "is a risk out there but it's still small".

The risk is that the recession will be longer and the recovery weaker than expected as consumers retrench. Until 1982 recessions were often induced by the Fed to weaken demand and reduce inflation. Declines in GDP were dominated by business inventories and interest-sensitive spending such as cars and houses. Once the Fed eased money, spending sprang back.

Since then inventories have become less important to the business cycle and deregulation and financial innovation mean higher interest rates take longer to affect spending. Expansions are marked by sizeable growth in assets and debt. When the cycle turns, falling asset values and debt reduction weaken the kick of lower rates, producing anaemic recoveries with rising unemployment. The Fed has already lowered its interest-rate target to 1%, but it is fighting gale-force headwinds as lenders reduce their loan portfolios. Citigroup recently told many of its credit-card holders that it was raising their interest rates by up to three percentage points.

Lenders once routinely pooled credit-card, student and car loans into securities and sold them to capital-markets investors. Joseph Astorina of Barclays Capital says no one wants to buy such securities now for fear that some overextended investor will dump its own holdings a week later, driving their values down sharply. The issuance of credit-card-backed securities, which averaged $8 billion a month in 2007, was zero in October, he says.

Alan Greenspan, the former Fed Chairman, told *The Economist* this week that banks were satisfied with capital equal to 10% of their assets in the past. Now, to soothe depositors and investors, they will need a much higher ratio—perhaps around 15%. Until they get there, through a combination of raising new capital, reducing dividends and share buybacks, and shedding assets, lending will be constrained.

This makes a strong case for more government stimulus. Lawrence Summers, the former treasury secretary and a candidate for the same post under Barack Obama, said on November 17th that it should be "speedy, substantial and sustained over a several-year interval". Fiscal stimulus at this stage would replace some of the demand which has been wiped out by the credit crunch. It won't prevent a recession; but without it, the recession is guaranteed to be far worse.